



# **WESTPAC: THE HOLY GRAIL OF TAX AVOIDANCE?**

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A dissertation submitted to  
Auckland University of Technology  
In partial fulfilment of the requirements for the degree of  
Master of Business (MBus)

2011

School of Business

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## **I. Attestation of Authorship**

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

.....  
Michael Macdonald

## II. Abstract

In this paper the writer looks to see whether the current anti-avoidance provisions are being correctly applied. It looks at the application of these provisions in light of the judgment of *Elmiger and Another v Commissioner of Inland Revenue*<sup>1</sup> since this was the approach promulgated by Dr A. M. Findlay when the rewrite of the income tax legislation was being enacted through the introduction of the Income Tax Act 1976 (“the ITA 1976”).

This determination will be made by analysing four of the recent major tax avoidance cases to see how the judiciary have come to their decisions. Particular focus will be given to the case of *Westpac Banking Corporation v The Commissioner of Inland Revenue*<sup>2</sup> as this is seen as the leading case involving tax avoidance in New Zealand given that Harrison J had the chance to reflect upon the decision of *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*<sup>3</sup> before releasing his judgment.

Despite the best intentions of both Parliament and the judiciary it is considered that the anti-avoidance provisions and their application require modification in order to provide greater certainty going forward and greater strength to the provisions themselves. This is not to be achieved at the expense of tax benefits genuinely intended by Parliament. Much of the changes suggested in this paper requires action by Parliament in order for the anti-avoidance provisions to be rewritten so that greater certainty can be placed on the judicial approach to the provisions and that perceived weaknesses in the wording of the provisions and associated legislation can be addressed.

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<sup>1</sup>*Elmiger and Another v Commissioner of Inland Revenue* (1966) NZLR 683 (SC) [Elmiger].

<sup>2</sup>*Westpac Banking Corporation v The Commissioner of Inland Revenue* (2009) 24 NZTC 23,834 (HC) [Westpac].

<sup>3</sup>*Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289 (SC) [Ben Nevis].

### **III. Acknowledgements**

I would like to thank Chris Ohms for taking the time to be my supervisor during this process.

Thanks is also given to Shobha Gautam for proofreading this paper.

I would also like to thank Barry Macdonald for providing constant motivation while I was studying.

Finally I would like to thank Guru Singh, Richard Phauv, Bruce Otway and Rakesh Gosai for their support during this time.

## IV. Introduction

Tax legislation, by its very nature, will always provide opportunities for tax avoidance. It is a complex piece of legislation that is designed to address the competing goals and needs of different sectors of society. On the one hand the Government wants to raise as much revenue as possible, but at the same time it has social policies, such as working for families, that need to be fulfilled. In an attempt to balance these competing needs structural inequalities arise within the legislation that enable tax benefits to be obtained in circumstances that were never intended by Parliament.

To address these issues anti-avoidance provisions have been introduced into the legislation as a means to prevent the erosion of the tax base. This started with the introduction of section 62 of the Land Tax Act 1878 (“the LTA 1878”) and has culminated in BG1 of the Income Tax Act 2007 (“the ITA 2007”).

The unfortunate side effect of the anti-avoidance provisions is that in order for them to be most effective they have to be broadly written so as to encompass all true tax avoidance arrangements. This leads to a situation where techniques of judicial interpretation must be applied. But that in itself can lead to debate amongst the judiciary. To overcome this, what appears, on the face of it, to be a robust framework has been developed to help analyse all potential tax avoidance arrangements.

*Westpac*<sup>4</sup> has come near the end of a long line of tax avoidance cases that have been used as a basis for developing this framework and it is often cited as a leading case of tax avoidance in New Zealand. So has this case been able to provide a settled approach to the application of the anti-avoidance provisions?

To address this question the paper will be divided into four broad areas:

1. The statutory framework by which tax avoidance is analysed
2. The history of how the framework came into being, including a brief analysis of the key cases that have influenced the evolution of the framework

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<sup>4</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2.

3. A detailed analysis of *Westpac*<sup>5</sup> and other current leading tax avoidance cases in order to show whether the framework is being correctly applied
4. Finally if it is determined that *Westpac*<sup>6</sup> has not provided a settled approach to tax avoidance an analysis of the framework and legislation will be undertaken in order to some potential solutions to the problems identified.

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<sup>5</sup> Ibid.

<sup>6</sup> Ibid.



## V. Statutory Framework

The current anti-avoidance provisions contained in section BG1 of the ITA 2007, simply provides that a tax avoidance arrangement is void as against the Commissioner for income tax purposes and that 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.

The term “tax avoidance arrangement” is contained in section YA1 of the ITA 2007 and is defined as:

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

From the definition of the term “tax avoidance arrangement” it can be seen that are three key elements that must be determined before the Commissioner can apply the anti-avoidance legislation. These elements are defined in section YA1 of the ITA 2007 and are as follows:

1. There must be an arrangement
2. The arrangement must involve tax avoidance as at least one of its purposes or effects
3. The tax avoidance purpose or effect has to be more than merely incidental

The first element is that there must be an “arrangement”. An “arrangement” is defined to mean an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect. The definition of this term was derived from the case of *Newton v Federal Commissioners of Taxation*<sup>7</sup> where Lord Denning stated that:

Their Lordships are of the opinion that the word ‘arrangement’ is apt to describe something less than a binding contract or agreement, something in the nature of an understanding between two or more persons – a plan

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<sup>7</sup> *Newton v Federal Commissioners of Taxation* [1958] AC 450, at 465(PC) [Newton].

arranged between them which may not be enforceable at law. But it must in this section comprehend, not only the initial plan but also all the transactions by which it is carried into effect – all the transactions, that is, which have the effect of avoiding taxation, be they conveyances, transfers or anything else.

This definition requires one to look to the effect of the arrangement in order to determine the extent of the arrangement.

The second element requires that there be tax avoidance. Tax avoidance includes<sup>8</sup>:

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

The third element requires that one of the purposes or effects of the arrangement be tax avoidance, with that purpose or effect being more than merely incidental. The term “purpose or effect” was defined in the case of *Newton*<sup>9</sup> where Lord Denning stated that:

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

While the tax avoidance purpose or effect does not have to be greater than 50% for the legislation to apply it does not mean that all transactions giving rise to a taxation benefit will be caught. Based on the decision of Woodhouse P in *Commissioner of Inland Revenue v Challenge Corporation Limited*<sup>10</sup> the term “more than merely incidental” was held to mean “... something which is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant.”

This means that when a transaction can be seen as part of ordinary business or family dealings and not as mechanism to avoid tax then section BG1 cannot apply.

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<sup>8</sup> Section YA 1 of the Income Tax Act 2007.

<sup>9</sup> *Newton v Federal Commissioners of Taxation*, above n 7.

<sup>10</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited* (1986) 8 NZTC 5,001, at 5,006 (CA) [Challenge Corporation].

A fourth element, not defined in the legislation, was introduced by Lord Hoffmann in the decision he delivered in the case of *O'Neil & Ors v Commissioner of Inland Revenue*<sup>11</sup>. This was to be known as the “Choice Doctrine.” Under this principle one is required to analyse the arrangement entered into by the taxpayer to determine whether the tax benefit derived from that arrangement was obtained by the taxpayer in a manner that was intended by Parliament when the specific legislation was introduced. Further analysis and discussion on this case will be found later in this dissertation.

In the second part of section BG1 of the ITA 2007 the Commissioner is given the discretion, in accordance with section Part G to counteract the tax advantage that was obtained by a taxpayer from a tax avoidance arrangement. The general power of reconstruction is contained in section GA1<sup>12</sup> of the ITA 2007.

In the case of *Miller v Commissioner of Inland Revenue; Managed Fashions Ltd and Ors v Commissioner of Inland Revenue*<sup>13</sup> Blanchard J addresses the extent of the Commissioner’s powers when it came to countering the tax advantage obtained.

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<sup>11</sup>*O'Neil & Ors v Commissioner of Inland Revenue* (2001) 20 NZTC 17,051 (PC) [O'Neil].

<sup>12</sup>The key components of GA1 of the ITA are:

Commissioner’s general power

(2) The Commissioner may adjust the taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate, in order to counteract a tax advantage obtained by the person from or under the arrangement.

Commissioner’s specific power over tax credits

(3) The Commissioner may—

- (a) disallow some or all of a tax credit of a person affected by the arrangement; or
- (b) allow another person to benefit from some or all of the tax credit.

Commissioner’s identification of hypothetical situation

(4) When applying subsections (2) and (3), the Commissioner may have regard to 1 or more of the amounts listed in subsection (5) which, in the Commissioner’s opinion, had the arrangement not occurred, the person—

- (a) would have had; or
- (b) would in all likelihood have had; or
- (c) might be expected to have had.

Reconstructed amounts

(5) The amounts referred to in subsection (4) are—

- (a) an amount of income of the person;
- (b) an amount of deduction of the person;
- (c) an amount of tax loss of the person;
- (d) an amount of tax credit of the person.

No double counting

(6) When applying subsection (2), if the Commissioner includes an amount of income or deduction in calculating the taxable income of the person, it must not be included in calculating the taxable income of another person.

Meaning of tax credit

(7) In this section, **tax credit** means a reduction in the tax a person must pay because of—

- (a) a credit allowed for a payment by the person of an amount of tax or of another item; or
- (b) another type of benefit.

<sup>13</sup>*Miller v Commissioner of Inland Revenue; Managed Fashions Ltd and Ors v Commissioner of Inland Revenue* (1998) 18 NZTC 13,961, at 13,980 (CA) [Miller].

Section 99(3) gives the Commissioner a wide re-constructive 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.

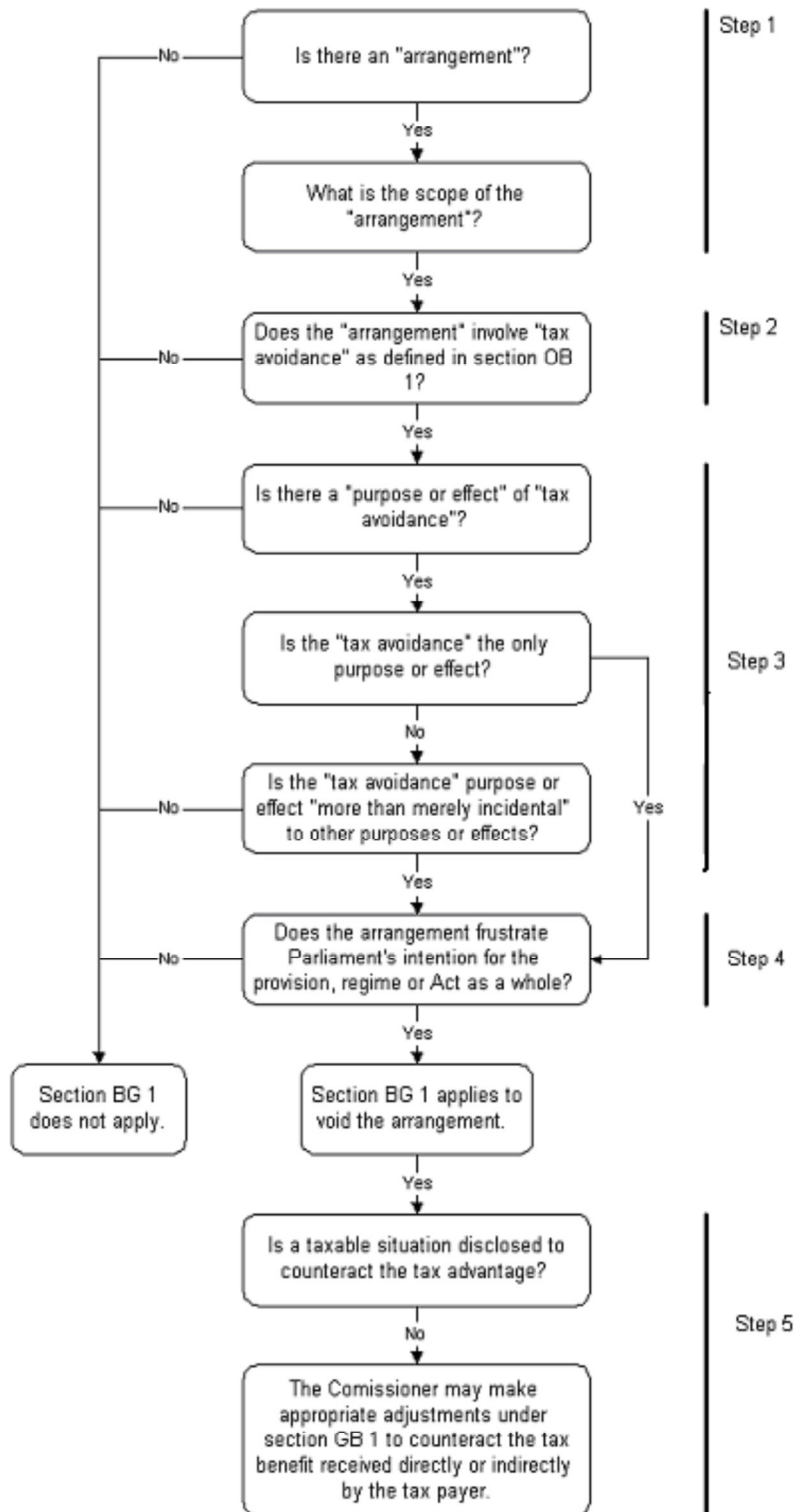
This requires that when the Commissioner is reconstructing the effect of a tax avoidance arrangement to look at the most likely hypothetical scenario as what would have happened if not for the arrangement<sup>14</sup>.

Reproduced below is a flowchart from an exposure draft issued by Inland Revenue in 2004 that summarises the process for applying sections BG1 and GB1 of the Income Tax Act 2004 (“the ITA 2004”)<sup>15</sup>.

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<sup>14</sup> Inland Revenue *INA0009 Interpretation of Sections BG1 and GB1 of the Income Tax Act 2004* (2004).

<sup>15</sup> *Ibid.*



While this flowchart is based on the wording of the legislation as contained in the Income Tax Act 2004 ("the ITA 2004"), it remains applicable as there were no intended changes to the anti-avoidance provisions when the ITA 2007 was introduced.

From the analysis of the statutory framework it can be seen that the process of identifying an offending arrangement and countering the tax advantage obtained involves the five following steps:

1. Determining the arrangement and its scope;
2. Determining whether the arrangement has tax avoidance for at least one of its purposes or effects;
3. Determining that the tax avoidance purpose or effect is more than merely incidental
4. Determining Parliament's intention in regard to the specific provisions applied to the arrangement
5. Reconstruction of the arrangement to counter the tax advantage obtained.

## VI. The History of Tax Avoidance in New Zealand

But how did New Zealand arrive at the current statutory framework for tax avoidance that is currently being applied? Outlined below is a brief summary of the journey and an analysis of some of the leading New Zealand tax avoidance cases that have influenced the interpretation of the anti-avoidance provisions.

Anti-avoidance legislation has been in play in New Zealand since the introduction of section 62 of the Land Tax Act 1878. Given the nature of the legislation when it was enacted its primary focus was on arrangements that attempted to circumvent the imposition of land tax. The Land and Income Tax Assessment Act 1891 enabled arrangements that attempted to avoid the imposition of income tax to also to be targeted. A further rewrite of the anti-avoidance provisions introduced section 162 of the Land and Income Tax Assessment Act 1916 which remained in place, relatively unchanged, until the introduction of section 99 of the ITA 1976.

The first tax avoidance case to be decided in favour of the Commissioner of Inland Revenue was *Elmiger*<sup>16</sup>. As will be discussed later in this paper, this case became the basis by which the current line of tax avoidance cases were to be determined. Therefore it is necessary to undertake an in-depth analysis of the case as this will form part of the basis for determining whether the current line of cases are correctly applying the anti-avoidance provisions as intended by Parliament.

### a. *Elmiger and Another v Commissioner of Inland Revenue*<sup>17</sup>

*Elmiger*<sup>18</sup> was the first case in New Zealand that applied any form of the anti-avoidance legislation in favour of the Commissioner of Inland Revenue. The decision from this case was based on section 108 of the Land and Income Tax 1954 (“the LITA 1954”) which stated that:

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<sup>16</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>17</sup> *Ibid.*

<sup>18</sup> *Ibid.*

Every contract, agreement or arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void 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.

### **i. Facts**

On 12 November 1962 two brothers involved in an agricultural contracting partnership established a trust that was settled by their father for £10. The beneficiaries of the trust were the wives and children of the brothers. When the trust was to cease on 31 March 1968 all capital was to revert back to the brothers.

On 28 November 1962 the partnership sold two earth moving machines to the trust for £5,250 by way of an interest free loan. The machines were then leased back to the partnership for £3 and £2/hr or a minimum monthly charge of £250 and £175 respectively. All outgoings in relation to the operation of the machines were to be borne by the partnership.

The agreements commenced on 1 December 1962. Hire charges for the next four months totalled £3,355. This amount was not paid by the partnership, but was instead offset against the loan owing by the trust. It was found that for the income year ended 31 March 1964 the partnership generated a loss of £100. As a result the partners in their capacities as trustees decided to reduce the hire fee charged. Accordingly the charge was reduced by £3,500 to £4,300 for the year. Of this amount £1,895 was applied as a set off against the remaining loan balance. £1,460 was then treated as an interest free loan from the trust to the partnership. The balance of approximately £950 was applied to various payments for the trust. No evidence was supplied to support the nature of the payments made.

The end result from this is that for the sixteen months in question the appellants retained a sum of £6,710 from the hire charges, via the trust, and were able to claim a deduction of £7,655 against the business income of the partnership.



## ii. Analysis

When arriving at his judgment Woodhouse J placed heavy reliance upon the decision of *Newton*<sup>19</sup>. From the ruling delivered by Lord Denning in that case Woodhouse J determined that it was necessary to analyse the following elements to determine whether the taxpayer had entered into a tax avoidance arrangement:

1. The arrangement entered into by the parties
2. Whether a tax advantage was obtained.
3. The purpose or effect of the arrangement

When defining the term ‘arrangement’ reference was made to the definition contained in the *Newton*<sup>20</sup> case. From this definition of the term ‘arrangement’ one can see that it is necessary to look to the effect of the arrangement in order to determine the extent of the arrangement and all of its constituent parts.

As the definition of ‘arrangement’ contained in *Newton*<sup>21</sup> could catch arrangements outside the scope of anything ever contemplated by Parliament, Lord Denning, in *Newton*<sup>22</sup>, introduced what is now known as the ‘Newton Predication Test’ where it was stated that:

In order to bring the arrangement within the section you must be able to predicate – by looking at the overt acts by which it was implemented – that it was implemented in that particular way 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.

Woodhouse J<sup>23</sup> concluded that for an arrangement to be a tax avoidance arrangement it was necessary to show that the “income tax advantage was one of the actuating purposes of the transaction under scrutiny or review”. This meant that the tax avoidance purpose only need to be more than merely incidental, rather than the

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<sup>19</sup> *Newton v Federal Commissioners of Taxation*, above n 7.

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

<sup>21</sup> *Ibid.*, at 465.

<sup>22</sup> *Newton v Federal Commissioners of Taxation*, above n 7, at 466.

<sup>23</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1, at 694.

dominant purpose for the existence of the arrangement as required by the Australian legislation<sup>24</sup>. If the arrangement was explainable by reference to ordinary family or business dealings and the tax effect of the arrangement was not pursued as a goal in itself then the arrangement could not be held as being a tax avoidance arrangement.

In terms of the tax benefit arising from the arrangement the partners put forward the argument that section 108 of the LITA 1954 could only apply to income that had been derived. In this case the partners' had not derived the income in question. Rather, this income was derived by the trust and it was the trust that was subject to the income tax liability. With reference back to the *Newton*<sup>25</sup> case, Woodhouse J<sup>26</sup> recognised that the Australian judiciary had identified the subtle differences in the words “to relieve”, referring to an existing tax liability and “avoid”, referring to a future liability for tax, enabling different outcomes to be achieved depending upon which subsection of the anti- avoidance provision was being applied. Woodhouse J<sup>27</sup> could not agree with this analysis as he concluded:

In my opinion the two limbs of the section are looking to the future, and I think it is in this sense that they should be construed. Its whole purpose appears to be to effect a general proscription of schemes which would have the affect of diverting potentially taxable income outside the ordinary

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<sup>24</sup> Section 260 of the Income Tax Assessment Act 1936

**INCOME TAX ASSESSMENT ACT 1936 - SECT 260**  
**Contracts to evade tax void**

(1) Every contract, [agreement](#), or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly:

- (a) altering the incidence of any income tax;
- (b) relieving any [person](#) from liability to pay any income tax or make any [return](#);
- (c) defeating, evading, or avoiding any duty or liability imposed on any [person](#) by this Act; or
- (d) preventing the operation of this Act in any respect;

be absolutely void, as against the [Commissioner](#), or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose.

(2) This section does not apply to any contract, [agreement](#) or arrangement made or entered into after 27 May 1981.

<sup>25</sup> *Newton v Federal Commissioners of Taxation*, above n 7.

<sup>26</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1, at 692

<sup>27</sup> *Ibid.* .

operation of the Act and thus preventing a liability for tax on that income from coming into existence. ...

As was said by Lord Denning in the Newton case on this basis the words would be deprived of any effect because “no one can displace a liability to tax which has already accrued due or in respect of income which has already been derived.

To that end Woodhouse J defined the arrangement as involving the following steps:

1. The establishment of the trust.
2. The sale of the machinery to the trust
3. An agreement by which the partnership would hire the machinery from the trust

It was further held that the arrangement was one of tax avoidance as its characteristics could not be explained by ordinary family dealings<sup>28</sup>. This was because the amounts paid in hire charges remained in the hands of the partners in the form of either a capital receipt or a loan and in due course the capital of the trust would revert back to the individual partners. It was therefore determined that the income tax purpose of the arrangement completely overrode any family reasons for entering into the arrangement.

As a result it was determined that the partners had derived a tax benefit from the arrangement because that had shifted income into the trust, via hire payments, that would have otherwise been assessable in the hands of the partners.

## **b. After Elmiger**

With the introduction of the ITA 1976 a greater level of certainty was given to the application of the anti-avoidance provisions contained within the act. In 1974 section 108 of the LITA 1954 was rewritten to become section 99 of the ITA 1976. Although the wording of the section had completely changed Dr A. M. Findlay, in the New Zealand Parliamentary Debates<sup>29</sup>, stated that while the section had been in existence for

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<sup>28</sup> Ibid, at 694.

<sup>29</sup> Findlay, A. M. (1974). Land and Income Tax Amendment Bill (No 2). *New Zealand Parliamentary Debates*, 393, 4191 at 4,191.

quite some time its objective remained the same, with that objective being written into legislation as “agreements purporting to alter incidence of taxation to be void.”

The reality was that section 108 of the LITA 1954 was rewritten to provide greater certainty as to the types of transactions that would be caught by the anti-avoidance provisions and to restore the power of *Elmiger*<sup>30</sup>. Dr. A. M. Findlay emphasised this point when he stated that<sup>31</sup>:

If people choose to avoid their income tax by disposing of their income in a way that is totally different from the normal pattern of ordinary folks’ spending, then I believe it is proper that it should be treated as it really is – as a device to avoid bearing their share of the cost of running the community. The courts ought to be armed, as they have been on the example of *Elmiger*, to strike down, and I am very much in favour of restoring the authority of *Elmiger* and perfecting the drafting lacuna to which attention was drawn by the Privy Council in *Peate*’s case.

This was considered necessary as the Privy Council in *Mangin v Commissioner of Inland Revenue*<sup>32</sup> adopted an approach, where tax avoidance was required to be the sole or principal purpose of the arrangement.

It can be seen from the current wording of the legislation that has been worded in order to align itself with the decision of *Elmiger*<sup>33</sup>. Take the definition of the term ‘arrangement’ as an example. As previously mentioned the term is defined in section YA 1 of the ITA 2007 as being “... an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect.”

While not copied word for word, this definition clearly has its origins based in the case of *Newton*<sup>34</sup> that Woodhouse J followed in *Elmiger*<sup>35</sup>. From this one can identify that the legislation follows the mandate put forward by Dr. A. M. Findlay<sup>36</sup> upon the introduction of the ITA 1976.

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<sup>30</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>31</sup> Findlay, A. M. (1974). Land and Income Tax Amendment Bill (No 2). *New Zealand Parliamentary Debates*, 393, 4191 at 4,194.

<sup>32</sup> *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 (PC) [Mangin].

<sup>33</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>34</sup> *Newton v Federal Commissioners of Taxation*, above n 7.

<sup>35</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>36</sup> Above at 26.

In 1990 the Commissioner of Inland Revenue released a policy statement<sup>37</sup> on section 99 of the ITA 1976. The statement referred to the cases of *Newton*<sup>38</sup> and *Challenge Corporation*<sup>39</sup> and made general mention of cases heard during the 1960's to aid in the interpretation of section 99 of the ITA 1976. The policy statement outlined the following four steps that required analysis before section 99 could be applied:

1. The scheme and purpose of the Act and the specific section in question;
2. The arrangement to determine its purpose or effect;
3. That it can be inferred that tax avoidance is one of the purposes of the arrangement, being a more than merely incidental purpose;
4. The arrangement frustrates the scheme and purpose of the Act.

Section BG1 of the Income Tax Act 1994 (“the ITA 1994”) replaced section 99 of the ITA 1976. In 2004 Inland Revenue released an exposure draft on relation to the interpretation of sections BG1 and GB1 of the ITA 2004<sup>40</sup>. To date a final version of this document has never been released. Inland Revenue has not expressed a reason as to why a final version has not been published.

While the Income Tax legislation has gone through three reincarnations since the implementation of the ITA 1976, the general anti-avoidance legislation contained in section BG1 of the ITA 2007 has remained relatively unchanged. Given the lack of change in the general anti-avoidance provisions since the introduction of section 99 of the ITA 1976 chapter VII of this paper will analyse four of the recent high profile tax avoidance cases to determine whether the legislation is being correctly applied in light of the promulgation by Dr Findlay in the New Zealand Parliamentary Debates<sup>41</sup> that the analysis contained in the case of *Elmiger*<sup>42</sup> is the correct approach to be followed when determining whether an arrangement entered into by a taxpayer can be subject to the anti-avoidance provisions.

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<sup>37</sup> Tax Information Bulletin, Vol 1 No. 8 February 1990, Appendix C.

<sup>38</sup> *Newton v Federal Commissioners of Taxation*, above n 7.

<sup>39</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited* [1986] 2 NZLR 513 (PC).

<sup>40</sup> Inland Revenue *INA0009 Interpretation of Sections BG1 and GB1 of the Income Tax Act 2004* (2004).

<sup>41</sup> *Miller*, above n 13.

<sup>42</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

### c. Judicial History

Although it is clear that the current wording of the anti-avoidance provisions are based on the judgment of *Elmiger*<sup>43</sup>, to fully understand the basis behind how the current line of tax avoidance cases, starting with *Ben Nevis*<sup>44</sup>, have been decided it is necessary to look at the judicial history of the anti-avoidance provisions post *Elmiger*<sup>45</sup>.

This analysis will look to the key issues raised in these cases that have helped shape and influence the judiciary's interpretation of the anti-avoidance provisions.

#### i. *Mangin v Commissioner of Inland Revenue*<sup>46</sup>

*Mangin*<sup>47</sup> involved the taxpayer restructuring his farming business via a trust to lease 25 of 385 acres of the farm for a rent of £3 per acre, with the farmer being employed and paid accordingly by the trust for his services. Via a separate trust deed the income arising from the cultivation of the wheat was to be held for the benefit of the farmer's wife and children.

The following year resulted in a transaction of a similar nature being implemented. This involved 24 acres being leased to the trust for £4 an acre. Again the farmer was employed by the trust to cultivate wheat on the land and to account for the net proceeds to the trustees. The farmer, just like in the previous year was remunerated for his services, with the net income from the trust being distributed for the benefit of the wife and children.

These two transactions resulted in part of what would have otherwise have been the farmer's income being distributed to his wife and children. This thereby enabled further allowances to be claimed and for the tax on the assessable income to be charged at a much reduced rate.

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<sup>43</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>44</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>45</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>46</sup> *Mangin v Commissioner of Inland Revenue*, above n 32.

<sup>47</sup> *Ibid.*

In this judgment further exploration of the term ‘tax avoidance’ was undertaken by their Lordships’ in order to determine the types of transactions that would be caught by the legislation. Their Lordships’ ultimately determined that<sup>48</sup>:

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 sec. 108.

This meant that arrangements enabling a tax benefit to be obtained without the taxpayer having to incur the economic cost of that benefit could potentially be treated as void by the Commissioner.

Their Lordships went on to further qualify the operation of section 108 of the LITA 1954 by analysing a quote of Lord Denning, in *Newton*<sup>49</sup>, where he stated that introduced what is now known as the “Newton Predication Test. From this their Lordships’ concluded that it was necessary to show that tax avoidance be the principal purpose or effect of the arrangement when they stated that<sup>50</sup>:

The clue to Lord Denning’s meaning lies in the words “without necessarily being labelled as a means to avoid tax”. Neither of the examples above given could justly be so labelled. 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.”

This had the effect of limiting the scope of the transactions to which the anti-avoidance provisions could be applied.

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<sup>48</sup> Ibid, at 596.

<sup>49</sup> *Newton v Federal Commissioners of Taxation*, above n 7, at 465.

<sup>50</sup> *Mangin v Commissioner of Inland Revenue*, above n 32, at 598.

## **ii. Commissioner of Inland Revenue v Europa Oil (N.Z.) Ltd<sup>51</sup>**

The taxpayer was in the business of marketing petroleum products and had a supply contract with Caltex which was due to expire on 1 December 1956. During the renewal negotiations with Caltex the taxpayer was unable to secure concessions as to the price paid for the product. The taxpayer then turned to Gulf Oil Corporation to secure their supplies.

The pricing structure adopted by the oil industry was based on “posted prices”, being the market price for bulk supplies. Discounts were not granted on those posted prices, but other inducements were offered. Gulf Oil Corporation had difficulties in providing any inducements due to supply agreements it had with another company. The taxpayer eventually obtained some concessions that led to the parties entering into an agreement.

Three contracts were entered into; all dated 3 April 1956, being The Products Contract, The Affreightment Contract and The Organisation Contract. The Products Contract was made with a subsidiary of Gulf Oil Corporation for a period of 10 years, whereby the subsidiary would supply the entire product required by the taxpayer at the posted price. Under The Affreightment Contract a reduced freight cost was obtained. The Organisation Contract required the incorporation of a company in the Bahama Islands, Pan Eastern Refining Co. Limited, with each party to hold an equal shareholding. The shareholding was not held direct, but by subsidiaries instead.

A subsequent agreement, being The Processing Contract, was entered into between Gulf Oil Corporation and Pan Eastern Refining Co. Limited. The contract required that Pan Eastern Refining Co. Limited purchase, at posted prices, sufficient oil in order to produce the necessary gasoline under The Products Contract. Gulf Oil Corporation proceed the oil for a fee payable by Pan Eastern Refining Co. Limited. The agreement was achieved by book entries in the accounts of Pan Eastern Refining Co. Limited. These entries recorded payments of approximately 5c per gallon of gasoline purchased by the taxpayer, that could vary based on the price of crude oil and gasoline.

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<sup>51</sup> Commissioner of Inland Revenue v Europa Oil (N.Z.) Ltd 70 ATC 6,012 (PC) [Europa Oil].



The result of these agreements was that, while the taxpayer did not receive a direct discount on the purchase price of the product, it was, via a subsidiary, entitled half the profits derived by Pan Eastern Refining Co. Limited.

*IRC v Duke of Westminster*<sup>52</sup> established that when determining the tax liability of a person it was necessary to look to the form of the contracts executed in order to determine that liability. One was not entitled to look to the economic substance of the contracts executed in order to determine that liability.

*Europa Oil*<sup>53</sup> departed from this approach as it would have required each of the contracts be viewed in isolation, preventing the legal form by which the concession was obtained to be determined.

### **iii. Commissioner of Inland Revenue v Challenge Corporation Limited<sup>54</sup>**

In 1977 the Securitibank Group of companies was placed in liquidation. On advice from an external accountant it decided to sell one of the subsidiaries that had significant losses of \$5 million. Due to the uncertainty as to the treatment of the loss advice was sought from Inland Revenue.

The proposal put forward to Inland Revenue was that the share capital of the company would be increased by \$5 million before 31 March 1978. Another shareholder of the company and member of the Securitibank Group, Merbank Corporation Limited would acquire those shares. The company would then repay the debt owing to Merbank Corporation Limited. The loss that would have arisen to Merbank Corporation Limited, as a bad debt, would now be available to the taxpayer. Inland Revenue confirmed that the loss would be deductible.

A document dated 28 February 1978 recorded this agreement. The agreement stated that the company owed Merbank Corporation Limited \$5.8 million, with the share

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<sup>52</sup> *IRC v Duke of Westminster* (1935) 19 T.C. 490.

<sup>53</sup> *Commissioner of Inland Revenue v Europa Oil (NZ.) Ltd*, above n 51.

<sup>54</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited*, above n 39.

capital to be increased by the same amount, and Merbank Corporation Limited acquiring those shares. Shares owned by a minority would be on-sold to the taxpayer. On settlement \$10,000 was payable, plus a further sum of 22.5%, being half the tax rate, on the tax loss attributable to the company. The agreement also required that interest be paid on the tax benefits obtained.

In this case their Lordships introduced a concept of tax mitigation when they stated that<sup>55</sup>:

Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability. Section 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.

This concept had no previous judicial support as it had never been raised before.

By comparison tax avoidance was shown to be<sup>56</sup>:

In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax.

The distinction that their Lordships were trying to make was that in circumstances where a legitimate obligation was incurred that the anti-avoidance provisions could not be invoked. This was a reinforcement of the form over substance doctrine.

In addition their Lordships noted that it was not appropriate to limit the application of the anti-avoidance provisions just because the specific provision contained an anti-avoidance element of its own<sup>57</sup>.

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<sup>55</sup> Ibid, at 561.

<sup>56</sup> Ibid, at 562.

<sup>57</sup> Ibid, at 560.

#### iv. **O’Neil & Ors v Commissioner of Inland Revenue**<sup>58</sup>

This case involved the implementation of a scheme where the profits of trading companies were converted into capital receipts in the hands of the shareholders. This particular implementation of the scheme involved the shareholders of three profitable companies selling their shares to a company controlled by their accountant. The consideration for the transaction was determined on the basis of the expected net profits for the next four years. Consideration was given by way of a mortgage over the shares. By a declaration of trust the original shareholders held the shares on trust for the accountant’s company.

Under the agreements executed every six months the profitable companies were required to pay an administration and consultancy fee to the purchasing company. Via the grouping rules the administration income was offset against other losses. Of the funds received by the purchaser 77.5% were returned to the original shareholders as payment against the loans.

At the end of the scheme the shareholders had the right to repurchase the shares for a nominal amount that covered the debts of the company and provided a return to the accountant, or to buy a release of the option for an amount that would enable the scheme to be restarted.

In their decision their Lordships agreed with the reasoning of Baragwanath J in the High Court when they stated that<sup>59</sup>:

...the distinction between tax mitigation and tax avoidance is unhelpful: as the judge pithily said, it describes a conclusion rather than providing a signpost to it’...

To view it any other way would have limited the scope and application of the anti-avoidance provisions as arrangements giving rise to real obligations would have been excluded.

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<sup>58</sup> *O’Neil & Ors v Commissioner of Inland Revenue*, above n 11.

<sup>59</sup> *O’Neil & Ors v Commissioner of Inland Revenue*, above n 11, at 17,057.

In going against the decision of *Challenge Corporation*<sup>60</sup> their Lordships placed emphasis upon the operation of the choice doctrine to determine when it is appropriate to apply the anti-avoidance provisions as Lord Hoffmann stated that<sup>61</sup>:

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.

As a result of this judgment the choice doctrine has now become a fourth element that must be considered in light of any potential tax avoidance arrangement.

#### **v. Commissioner of Inland Revenue v BNZ Investments Limited<sup>62</sup>**

BNZ Investments Limited (“BNZI”) was a subsidiary of the Bank of New Zealand Limited (“BNZ”), fully funded by external debt, and entered into nine complex transactions, of four different varieties, involving redeemable preference (“RPS”) shares that were provided by Capital Markets Limited (“CML”). The funds from the RPS were invested in overseas bank and although interest was earned it was ultimately returned to BNZI as an exempt dividend. The rate of the dividend was determined so that BNZI and CML would share the tax benefits. The scheme was comprised of two elements known as ‘upstream’ and ‘downstream’. For the purposes of this paper one example of the upstream and downstream transaction will be addressed.

The upstream transactions involved four steps, with the first step being the borrowing of funds by which to capitalise BNZI. The second step involved the incorporation of BNZI by BNZ. With the receipt of the funds the third step involved a deposit by BNZI with BNZ. In the fourth step BNZI would invest in RPS issued by CML via borrowings guaranteed by a third party and a mortgage of securities. The return to BNZ was agreed to and set as a dividend rate.

The downstream transactions involved inter-entity investments with the final entity investing the funds in an overseas bank. To make this investment funds from a New

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<sup>60</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited*, above n 39.

<sup>61</sup> *O’Neil & Ors v Commissioner Of Inland Revenue*, above n 11 at 17,057.

<sup>62</sup> *Commissioner of Inland Revenue v BNZ Investments Limited* [2002] 1 NZLR 450 (CA), [BNZI].

Zealand resident company, a Hong Kong company and an entity resident in the Cook Islands tax haven were applied. This entity earned interest income that was received tax free from the investment. The interest was then flowed back through the structure and paid to BNZI as an exempt dividend due section 63(2) of the ITA 1976.

The result of this judgment was to significantly reduce the scope of arrangements to which the anti-avoidance provisions could be applied as it required there to be a meeting of minds, and it could not be shown that BNZI had knowledge of the wider downstream tax avoidance arrangement. On this point Richardson P said<sup>63</sup> at p 465:

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 descending order of the terms “contract, agreement, plan or understanding” suggests that there are descending degrees of enforceability, so that a contract is ordinarily but not necessarily legally enforceable, as is perhaps an agreement, while a plan or understanding may often not be legally enforceable. 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.

#### **vi. Peterson v Commissioner of Inland Revenue<sup>64</sup>**

This case involves an individual who, via a special partnership invested in two feature films as part of syndicate. The funding for the films was represented as a formula of \$x+y by their Lordships. \$x represented funds that were required to be provided by the syndicate from their own resources, while \$y represented a non-recourse loan obtained from a company associated with the production company. \$y was more than half of the total investment and also represented an amount by which the production costs were inflated. As \$y was not required by the production company it was immediately transferred across to the lender when received. From these investments the syndicate gained the right to licence and market the films. As a result the syndicate was entitled to depreciate this cost over a two year period. According to the prospectus for every \$1,000 invested a deduction of \$1,150 could be claimed.

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<sup>63</sup> Ibid, 465.

<sup>64</sup> *Peterson v Commissioner of Inland Revenue* [2006] 3 NZLR 433 (PC) [Peterson].

This judgment had the effect of expanding the scope of arrangements to which the anti-avoidance provisions could be applied and overturned the requirement to have a meeting of minds as promulgated in *BNZ Investments*<sup>65</sup> as Lord Millett stated<sup>66</sup>:

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

What this meant was that a person only needs to derive a tax benefit from a tax avoidance arrangement in order to be caught. It was not necessary for the Commissioner to show that the taxpayer had knowledge as to the nature of the arrangement being entered into, or for that matter the existence of the arrangement at all. In the circumstances the taxpayer incurred real expenditure and had not mitigated this obligation so was entitled to claim the depreciation deduction.

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<sup>65</sup> *Commissioner of Inland Revenue v BNZ Investments Limited*, above n 62.

<sup>66</sup> *Peterson v Commissioner of Inland Revenue*, above n 64, at 444.

## VII. Recent Tax Avoidance Cases

Although New Zealand has what appears to be a well-established and robust framework by which to analyse potential tax avoidance arrangements, one has to consider whether that framework is being correctly applied and whether there are any weaknesses in that framework, especially given that the recent line of cases are being predominantly decided in favour of the Commissioner.

To that extent an analysis of four recent major tax avoidance cases will be undertaken, with the emphasis being placed on *Westpac* as it is seen by many as the leading tax avoidance case in New Zealand as it has had a chance to consolidate the judicial findings in relation to the application of the anti-avoidance provisions that came out of the decision of *Ben Nevis*<sup>67</sup>.

### a. **Ben Nevis Forestry Ventures Limited v Commissioner of Inland Revenue**<sup>68</sup>

The appellants in this case were nine loss-attributing qualifying companies that had invested in a Douglas Fir Forestry project as part of a syndicate known as the Southern Lakes Joint Venture as part of what is known as the Trinity Scheme. The project was due to be harvested by 2048.

The project was established in 1997 when three subsidiaries of Trinity Foundation Limited acquired title to the land upon which the forest was to be planted. The ultimate owner of the land was to be the Trinity Foundation Charitable Trust by virtue of its ownership of Trinity Foundation Limited. It was the land owned by one of the subsidiaries (Trinity Foundation (Services No 3) Limited)) that was the subject of this dispute. Southern Lakes Forestry Limited was established to act as an agent for the syndicate.

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<sup>67</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>68</sup> *Ibid.*

Trinity Foundation (Services No 3) Limited and Southern Lakes Forestry Limited entered into two licence agreements. Under the first agreement granted the syndicate a licence to occupy the land for the purpose of conducting a forestry business on the property. A sum of \$2,050,518 per plantable hectare was to be paid as a licence premium at the expiry of its term. The second licence agreement specified that the licence was to run for the period of 24 March 1997 to 31 December 2048.

The second agreement required the syndicate, at their own expense, to establish and operate a Douglas Fir forest. The agreement also required that the syndicate should, during a four year period prior to the expiration of the licence agreement, arrange for the cutting and sale of the timber. Funds derived from this were to be applied by the landowner in the following order:

- GST
- Cost of sale
- Payment of promissory notes given by investors in relation to insurance premiums.

The balance of the proceeds from the sale of the timber was to be paid to the syndicate on 31 December 2048.

In addition the agreement also required that the syndicate pay Trinity Foundation (Services No 3) Limited \$1,350 per plantable hectare for the establishment of the forest, \$1,946 per plantable hectare for an option to purchase the land and \$1,000 each for the lease option. In addition there was an annual licence fee payable. All of this was over and above the licence premium payable.

Given that there was a risk that there would be insufficient net proceeds available from the sale of the timber to enable the syndicate to pay the licence premium due on 31 December 2048 insurance cover was arranged via a newly established company called CSI Insurance Group (BVI) Limited that was incorporated in the British Virgin Islands. Two premiums were payable under this policy. The first was \$1,307 per plantable hectare in 1997 and \$32,791 per plantable hectare on 31 December 2047. Trinity Foundation (Services No 3) Limited was also obliged to pay an insurance premium of \$410,104 per plantable hectare by 31 December 2047, subject to an increase up to



\$1,230,311 pre plantable hectare should the value of the net proceeds be less than \$2,050,518 per plantable hectare.

To cover the insurance premiums the syndicate members and Trinity Foundation (Services No 3) Limited issued promissory notes to cover their obligations. As a result of the promissory notes CSI Insurance Group (BVI) Limited was given first ranking rights to the forest. Trinity Foundation (Services No 3) Limited and the syndicate had second ranking securities to cover the obligations between them.

Due to the licence and insurance premiums payable the syndicate claimed the following deductions in the income year ended 31 March 1997:

\$1,307 per plantable hectare for the insurance premium payable in March 1997 and \$32,791 that was to be payable in December 2047; and  
An amortised portion of the licence premium.

For the income year ended 31 March 1998 approximately \$41,000 per plantable hectare was claimed for the full amortised portion of the licence premium.

There was no dispute concerning the other expense incurred by the syndicate in relation to the planting and maintenance of the forest.

The writer notes that the judgment did not apply the five step analysis in its traditional form, so has decided not to restructure the judgment to reflect the traditional application of that analysis.

#### **i. Arrangement**

Tipping, McGrath and Gault JJ concluded that at the heart of the anti-avoidance provisions contained within the Act was the concept of a ‘tax avoidance arrangement’<sup>69</sup>. In conjunction with the definition of the term ‘tax avoidance’ a tax avoidance arrangement, as defined by Parliament, was held to include an arrangement which directly or indirectly alters the incidence of any income tax. The term ‘arrangement’

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<sup>69</sup> Ibid, at 331.

was to include all steps by which it is carried out. It was determined that a tax avoidance arrangement could be comprised of a single step or a series of steps, which is the more common scenario. Even if each step in the arrangement meets the black letter of the law, the execution of the steps in combination can still give rise to a tax avoidance arrangement.

In its most simplistic form the arrangement was held to include all the steps necessary to enable the appellants to claim the licence and insurance premiums as a deduction<sup>70</sup>. Ultimately it was considered that there were two separate, but interrelated arrangements in this case. The first arrangement dealt with the licence premium while the second arrangement related to the insurance premiums.

Since the introduction of the anti-avoidance provisions in 1974<sup>71</sup> Parliament has chosen not to define what arrangements the provisions will apply to. Rather this has been left for the judiciary to determine. To do otherwise could narrow the application of the anti-avoidance provisions to the point where arrangements that should be caught are excluded. In undertaking this determination it is necessary for a principle approach to be applied whereby the particular facts are to be analysed in light of the respective legislative policy surrounding the specific provisions applied. This analysis must be applied objectively without subjective thoughts as to the morality of the arrangement that has been executed.

It was considered that the specific provisions and anti-avoidance provisions were designed to work in tandem, enabling the appropriate effect to be given to both provisions<sup>72</sup>. They are designed to work together, without one overriding the other. To have the provisions work in any other manner would deprive the anti-avoidance provisions of any effect.

It was determined that where a taxpayer has made use of a specific provision of the Act that it was necessary to undertake a twofold inquiry to determine whether the anti-avoidance provisions can be applied to counter the tax advantage obtained from the use

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<sup>70</sup> Ibid, at 333.

<sup>71</sup> Findlay, A. M. (1974). Land and Income Tax Amendment Bill (No 2). *New Zealand Parliamentary Debates*, 393, 4191, above n 29.

<sup>72</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3, at 330.

of that specific provision<sup>73</sup>. The first test required analysis as to whether the specific provision had been correctly applied. It was then necessary to view that use in light of the arrangement entered into to determine whether Parliament could have contemplated that the specific provision be utilised in such a manner.

While it is usually easy to determine whether a specific provision has been correctly applied, it is not so easy to determine whether the line had been crossed so as to bring it outside of Parliament's intention. To make this determination reliance could not be placed upon the legislation as it did not specify what matters could be considered. Rather it was considered that<sup>74</sup>:

... the Commissioner and the courts may address a number of relevant factors, the significance of which will depend upon the particular facts. The manner in which the arrangement is carried out will often be an important consideration. So will the role of all the relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of documents and transactions may also be significant. Other features that may be relevant include the duration of the arrangement and the nature and extent of the financial consequences that it will have for the taxpayer. As indicated, it will often be the combination of various elements in the arrangement which is significant. A classic indicator of a use that is outside parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner. In considering these matters, the courts are not limited to purely legal considerations. They should also consider the use made of the specific provision in the light of the commercial reality and the economic effect of that use. The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament's purpose. If that is so, the arrangement will not, by reason of that use, be a tax avoidance arrangement. If the use of the specific provision is beyond Parliamentary contemplation, its use in that way will result in the arrangement being a tax avoidance arrangement.

It was recognised that in the definition of tax avoidance that there was a requirement for the tax avoidance purpose or effect of the arrangement to be more than merely incidental. Therefore the use of a specific provision to derive a tax benefit was found to exist in only two situations. The first was when the specific provision was applied in a manner contemplated by Parliament. The second was when the tax effect from the use of the specific provision was 'merely incidental'<sup>75</sup>.

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<sup>73</sup> Ibid, at 331.

<sup>74</sup> Ibid, at 311.

<sup>75</sup> Ibid, at 333.

### Licence Premium

The licence premium enabled the appellants to claim a deduction of \$41,000 per plantable hectare. This was on the basis of a depreciation claim against the total licence premium payable. In reality the cash outlay was only \$50. It was contended by the parties that although the licence premium was not due and payable that it had been incurred on the basis of the promissory notes issued. The basis for this argument was the case of *Commissioner of Inland Revenue v Glen Eden Metal Spinners Limited*<sup>76</sup> where it was stated that<sup>77</sup>:

An expenditure is incurred in an income year although there has been no actual disbursement if in that year the taxpayer is definitely committed to that expenditure. ...There must be an ascertained liability but it is not necessary to constitute a definitive commitment that the liability is indefeasible: the taxpayer is equally committed whether or not its present liability may subsequently be diminished or avoided by the action of others. In marginal cases the distinction between a defeasible liability under which a taxpayer is definitely committed, and a contingent liability under which it is not, may not be easy to draw.

This approach was upheld in the case of *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited*<sup>78</sup> even though the interpretation involved a jurisprudential approach rather than a commercial one as to the meaning of the term 'incurred'. While Tipping, McGrath and Gault JJ did not endorse such an approach they were willing to continue their analysis based on this approach<sup>79</sup>. And although this approach was not commercial in its manner, it was still necessary for the commercial aspects to be reviewed as it is these factors that could lead to a conclusion that an arrangement entered into is one of tax avoidance.

The use of the promissory notes introduced an artificial element into the arrangement as they were not seen as means by which the payment of the licence premium in 2048 could be secured. Further there was a significant timing advantage obtained by delaying the payment until 2048. The shareholders of the Loss Attributing Qualifying Companies did not provide a personal guarantee for the licence premium, and in any event the shareholders are unlikely to be alive when the premium becomes due and payable. There was even a risk that the companies may not be in existence at this time either. In fact it was determined that there could be an advantage to the scheme being

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<sup>76</sup>*Commissioner of Inland Revenue v Glen Eden Metal Spinners Limited* (1990) 12 NZTC 7,270 (CA).

<sup>77</sup> Above at 4, at 333.

<sup>78</sup>*Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited* [1995] 3 NZLR 513 (PC).

<sup>79</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3, at 334.

wound up before 2048 as the appellants would be able to walk away from their obligation leaving Trinity Foundation (Services No 3) Limited with the benefit of the net stumpage proceeds.

There was also a real risk coming out of the arrangement that it would never be profitable. In fact there did not appear to be any commercial reason the licence premium to be charged in the first instance given that the syndicate had already provided the necessary funds for the purchase of the land. This raised concerns as to whether the arrangement entered into ever had a true commercial purpose. Even based on the appellants evidence as to how the licence premium had been determined there were indications that the scheme would never be profitable.

Concerns were also raised as to the real possibility that the appellants would never have to incur the payment of the licence premium. Factors such as the lack of security over assets or personal guarantees indicated that Trinity Foundation (Services No 3) Limited never intended for any payments to be received over and above the net stumpage proceeds.

If the net return from the scheme only amounted to the amount of the licence premium incurred then the only benefit that the syndicate would obtain was that of the available deductions.

While the establishment of the various entities involved in the arrangement and the agreements that they entered into would still remain in force according to their legal tenor. Yet there are some contingencies affecting the arrangement as the obligation to pay the licence premium lacked any reality as the obligation to make payment was based solely upon the net stumpage proceeds received. All of this has resulted in the appellants' use of the specific provisions relating to depreciation to be taken well outside anything Parliament could have intended and brought it within the realm of being part of a tax avoidance arrangement.

#### Insurance Arrangements

Tipping, McGrath and Gault JJ came to the opinion that the insurance contract was included for two main reasons<sup>80</sup>. The first was that it would provide security to the investors should the forestry scheme not deliver the returns expected. Secondly, and probably most importantly, it enabled a significant deduction to be claimed for tax purposes.

The establishment of a single purpose entity, based on the British Virgin Islands, to provide the insurance for the forestry scheme raised concerns as to the reasons for its establishment. As part of the establishment of CSI Insurance Group (BVI) Limited AMS Financial Services Limited, another British Virgin Islands company, was consulted. AMS Financial Services Limited was instructed on 16 January 1997 to incorporate the company. AMS Financial Services Limited sent a draft business plan to Dr Muir, who was the key mind behind the creation of this forestry scheme, via a letter dated 29 January 1997. In that letter it was stated that<sup>81</sup>:

The real benefits of the deal are tax concessions that can be obtained now by the investors and the foundation. One of the conditions required to gain the tax relief is that the insurance must be in place. The actual outcome of the deal in 50 years time is not considered material.

Furthermore, correspondence from AMS Financial Services Limited suggest that in order to give further substance to CSI Financial Services Group (BVI) Limited that an office should be established that had its own phone and fax lines as well as stationery. In reality this never happened and no office was ever established in the British Virgin Islands. This was confirmed by Dr Muir under cross-examination<sup>82</sup>. In addition amendments were made to the business plan whereby an “irrevocable letter of comfort” was supplied by the Trinity Foundation Charitable Trust. The undertaking provided that<sup>83</sup>:

... should CSI be unable to meet its obligations to the Trinity Foundation in 2048, The Trinity Foundation Charitable Trust will donate to CSI such sums as CSI is required to pay to The Trinity Foundation Ltd.

At all times Dr Muir made sure that all details regarding the insurance company were kept highly secret. Of the insurance premiums received 90% was paid to a company

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<sup>80</sup> Ibid, at 337.

<sup>81</sup> Ibid, at 338.

<sup>82</sup> Ibid, at 337.

<sup>83</sup> Ibid, at 338.

called Parentis by way of commissions and introduction fees. These funds were then on lent to trusts of Dr Muir and Mr Bradbury, another influential person behind the development of the scheme. These loans became due and payable in 2047<sup>84</sup>.

These factors added to the inference that the insurance premiums were unorthodox and lacked any commercial reality. The letter of comfort demonstrated the circularity of the whole arrangement as the risk borne by CSI Financial Services Group (BVI) Limited was ultimately covered by The Trinity Foundation Charitable Trust<sup>85</sup>.

While it was held on behalf of the syndicate that the purpose of the promissory notes was to provide CSI Financial Services Group (BVI) Limited with an easier means to ensure payment when the insurance premium became due and payable in 2047, rather than having to sue under contract. Tipping, McGrath and Gault JJ could not agree with this analysis as although it was correct at law, the substance of the transaction was to substitute one debt for another<sup>86</sup>. There was no real payment given in 1997. Rather it was just a means to claim a deduction up front. As a result it was determined that the insurance contract was significant to making the entire scheme a tax avoidance arrangement.

## **ii. Reconstruction**

The power by which the Commissioner was able to reconstruct this arrangement was contained in section GB1 of the ITA 2004. Under this section the Commissioner is entitled to issue an amended assessment so as to counter the tax advantage obtained by a taxpayer that has participated in a tax avoidance arrangement. To determine how to make this adjustment the Commissioner must consider the most likely scenario that would have taken place if it were not for the arrangement.

If the taxpayer wished to challenge an assessment raised by the Commissioner the onus of proof fell upon the taxpayer to show why and by how much the assessment was wrong. Following the case of *Buckley & Young Ltd v Commissioner of Inland*

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<sup>84</sup> Ibid, at 339.

<sup>85</sup> Ibid, at 340.

<sup>86</sup> Ibid.

*Revenue*<sup>87</sup>, if the taxpayer cannot show what the correct tax position should have been then they will fail and the Commissioner's assessment will stand.

The Commissioner's reconstruction was to disallow the licence premium claimed. From the appellants perspective this was seen to be highly uncommercial as it was seen that the Commissioner was effectively treating them as being able to use the land free of charge for the entire 50 year period. This proposition could not be sustained as the investors had already paid for the land. In addition, while not mentioned in the reconstruction, it had already been inferred in the judgment that the legal agreements entered into by the parties would hold true according to their legal tenor. Therefore the investors still had a legal obligation to pay the licence premium when it became due in 2048.

It was viewed that the appellants had not shown that the reconstruction and corresponding assessment were incorrect. Even if they had been able to do so an alternative basis for reconstruction was not provided for the Court to consider. Therefore it was determined that the Commissioner's assessment would stand.

## **b. Westpac Banking Corporation v The Commissioner of Inland Revenue<sup>88</sup>**

### **i. Deductibility**

Prior to analysing whether the transactions entered into by Westpac were part of a tax avoidance arrangement Harrison J looked to the tax treatment of those transactions under the specific provisions of the Act<sup>89</sup>. This was because it was submitted on behalf of the Commissioner that section BG1 only applied once the arrangement complies with the Act<sup>90</sup>.

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<sup>87</sup> *Buckley & Young Ltd v Commissioner of Inland Revenue* [1978] 2 NZLR 485 (CA) [Buckley & Young].

<sup>88</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2.

<sup>89</sup> *Ibid*, at 23,879.

<sup>90</sup> *Ibid*.



Harrison J assumed that the Commissioner based this interpretation on the first three sentences of [107] in the case of *Ben Nevis*<sup>91</sup>. In isolation such an interpretation was found to be plausible, but the correct interpretation was that an avoidance inquiry is not prohibited solely on the basis that there is compliance with a specific provision<sup>92</sup>.

If compliance with a specific provision was required before BG1 could be applied then an anomaly would arise. For example the disallowance of a minor deduction could prevent the arrangement as a whole from being analysed. To do so would be contrary to *Miller v Commissioner of Inland Revenue*<sup>93</sup>.

The logic behind determining the deductibility of the guarantee procurement fee and then determining whether the tax avoidance provisions applied was because the deductibility of the guarantee procurement fee was the key to the tax avoidance inquiry. The deductibility of the expenditure incurred was reviewed in light of the conduit tax and foreign tax credit regimes under which the transactions fell.

The transaction taken in relation to Koch, Rabo 1 and Rabo 2 came within the conduit tax regime. Under these rules a New Zealand resident company's shareholding in a foreign company is affected in the following manner<sup>94</sup>:

1. The income that would be attributed to the New Zealand resident company is offset by a tax credit under the controlled foreign company rule. The controlled foreign company rules are designed to prevent resident shareholders from deferring income by placing that income in a foreign company and not repatriating the profits of that company back to New Zealand as a dividend.
2. If any dividends are received from the foreign company section NH7 exempts them from the need to deduct a dividend withholding payment that would otherwise be payable.

These forms of relief only apply when the New Zealand company is foreign owned.

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<sup>91</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>92</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,880.

<sup>93</sup> *Miller*, above n 13..

<sup>94</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,886.

As a result the conduit tax regime had the following effect on the income derived by Westpac from Koch<sup>95</sup>:

1. TBNZI and its shareholder TBNZ Developments made the necessary elections and maintained conduit tax relief accounts.
2. Income derived from Kiwi by TBNZI was exempt from being attributed foreign income under the controlled foreign company regime due to it being a United States resident.
3. TBNZI declared the dividends received from Kiwi, but as conduit tax relief company was entitled to exemption from having to deduct a dividend withholding payment.
4. Under the thin capitalisation rules the debt and assets of the New Zealand group were reduced by the loans made to third parties on an arm's length basis.

The CSFB transaction fell to be taxed under the foreign tax credit regime. These rules were designed to prevent double taxation by allowing a tax credit for any foreign tax paid. The credit was limited to the lesser of the foreign tax paid and the New Zealand tax payable on that income.

Harrison J then went on to analyse whether the funding costs and interest expenditure was deductible<sup>96</sup>. Under section DD1(3) companies had an automatic deduction for interest. This was introduced in 2001 with retrospective effect from 1 April 1997. This automatic deduction did not apply when the company, or if it was part of a wholly owned group, derives exempt income, unless it is an exempt dividend.

In the definition of interest expenditure incurred under a financial arrangement, as part of subpart EH, is deductible under DD1(3). Westpac felt that due to these rules the interest deductibility rules applied as follows<sup>97</sup>:

1. That all the interest incurred by the Westpac group was fully deductible.
2. All expenditure incurred under the financial arrangements, such as the currency and interest swaps and the guarantee procurement fee, were automatically deductible.

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<sup>95</sup> Ibid, at 23,887.

<sup>96</sup> Ibid.

<sup>97</sup> Ibid, at 23,888.

3. At all times the debt asset ratio of the New Zealand Westpac group never exceed 75% under the thin capitalisation rules.

The guarantee procurement fee was central to the dispute between the Commissioner and Westpac, so the first question was whether the guarantee procurement fee was defined as interest under the financial arrangement rules and automatically deductible. At the time of entering into the Koch transaction subpart EH defined a financial arrangement as<sup>98</sup>:

- (a) any debt or debt instrument, and
- (b) any arrangement (whether or not such arrangement includes an arrangement that is a debt or debt instrument or excepted financial arrangement) whereby a person obtains money in consideration for a promise by any person to provide money to any person at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving, or failure to give notice), and
- (c) any arrangement which is of a substantially similar nature (including without restricting the generality of the preceding provisions of this subparagraph, sell back and buy-back arrangements, debt defeasances, and assignments of income) but does not include any excepted financial arrangement that is not part of a financial arrangement.

All other transactions entered into were caught by the new definition of financial arrangement that was introduced on 20 May 1999. In principle there was no difference in the overall meaning of the term.

The reason for adopting the guarantee procurement fee structure was because Westpac felt that CN4 would have imposed a liability for withholding tax on the basis that the payment of a guarantee would have been deemed to be a payment of insurance to an overseas provider<sup>99</sup>. Westpac held that the payment of the guarantee procurement fee had the same economic effect as the payment of a guarantee as it was in payable inconsideration for the KII fee itself. In addition Westpac believed that the definition of financial arrangement was sufficiently wide so as to include such arrangements, and

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<sup>98</sup> Ibid, at 23,890.

<sup>99</sup> Ibid.

was supported by a document issued by Inland Revenue's Policy Advice Division in December 1997 titled "*The Taxation of Financial Arrangements*". The document stated at 13.1 that:

A guarantee or other security arrangement for which a fee is paid to the guarantor will fall squarely within the definition of financial arrangement adopted by the accrual rules.

To support this contention *Buckley & Young*<sup>100</sup> was cited<sup>101</sup>, where it was stated that:

A deed or other instrument must be construed as a whole and, if the transaction is embodied in a number or complex of interrelated agreements, then all the agreements must be considered together and one may be read to explain the others.

In determining whether the guarantee procurement fee was paid under a financial arrangement Harrison J relied upon *Ben Nevis*<sup>102</sup> where it was stated<sup>103</sup>:

... the Court is concerned primarily with the legal structures and obligations the parties have created and not with conducting an analysis in terms of their economic substance and consequences, or of an alternative means that were available for achieving the substantive result.

This meant that Harrison J was required to undertake an analysis of the agreements entered into in relation to the guarantee procurement fee, rather than looking to the economic substance or the intended result of the agreement.

Clause 2.2 of the guarantee procurement fee agreement between TBNZI and KCS provided that in principal TBNZI would be required to pay a guarantee procurement fee to KCS in consideration for KCS procuring the issue and continuation of a guarantee from Koch Industries Inc<sup>104</sup>. This fee was to be paid at a rate of 2.85% per annum on the transfer price. Under this clause it was clearly stated that the payment of the guarantee procurement fee was not paid in for either KCS or KII promising to pay money at some future date. The guarantee provided by KII was documented via a deed. The deed itself made no reference to the guarantee procurement fee and as a deed did not require any consideration to be paid. The terms merely stated that the guarantee was

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<sup>100</sup> *Buckley & Young Ltd v Commissioner of Inland Revenue*, above n 85, at 490.

<sup>101</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,891.

<sup>102</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3, 316.

<sup>103</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,891.

<sup>104</sup> *Ibid.*

being provided to ensure the performance of KCS's obligations. From the contracts entered into it could not be seen that the guarantee procurement fee was required to be paid to KCS. As a result the fee could not have been paid in consideration for a guarantee and was there not part of a financial arrangement.

In the alternative Westpac argued that the guarantee procurement fee was incurred in the derivation of gross income so was therefore deductible in accordance with section BD2(1)(b)(i) or (ii) of the ITA 2007 so long as it had the necessary nexus<sup>105</sup>. BD2(2) of the ITA 2007 however, prohibited the deduction to the extent that the expenditure was :

- (a) of a private or domestic nature
- (b) incurred in deriving exempt income
- (c) of a capital nature.

The determination as to whether the shares in Kiwi were held on a capital or revenue was deemed to be a mainly factual exercise with only the authority of *Waylee Investments Limited v Commissioner of Inland Revenue (Hong Kong)*<sup>106</sup> being cited<sup>107</sup>. In this case a subsidiary was formed to buy the shares of a customer that was in trouble and in debt to the bank. Four years later the shares were sold. It was held that the shares were a capital asset on the basis that they were acquired to show confidence in their customer and could not be liquidated in order to meet depositors demands.

In light of this authority Harrison J concluded that the shares in Kiwi were a capital asset as TBNZI was prohibited from trading the shares so could not use them as part of their normal stock in trade. Therefore the guarantee procurement fee was paid in the acquisition of a capital asset.

As a second alternative Westpac argued that the shares were acquired for the purpose of resale, due to the obligations to resell the shares to KCS under the forward transfer agreement. Section CD4 would fall to tax any such disposal upon the exercise of the agreement. In *Commissioner of Inland Revenue v National Distributors*<sup>108</sup> it was stated that<sup>109</sup>:

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<sup>105</sup> Ibid, at 23,889.

<sup>106</sup> *Waylee Investments Limited v Commissioner of Inland Revenue (Hong Kong)* [1990] BTC 543.

<sup>107</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,896.

<sup>108</sup> *Commissioner of Inland Revenue v National Distributors* (1989) 11 NZTC 6,346 (CA).

<sup>109</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,898.

If the taxpayer's dominant purpose in acquiring the property is to sell it in the future at a price which, allowing for inflation, corresponds with or is better than its price at the time of purchase, his statutory purpose is to sell the property...

When TBNZI entered into the agreement to acquire the shares in Kiwi it was obliged to sell them back for the same price. This clearly goes against there being an intention to acquire the shares for the purpose of resale. Further, all evidence put forward indicated that the sole purpose for acquiring the shares was so that a cashflow in the form of a dividend could be derived. Therefore the guarantee procurement fee was paid predominantly for the purpose of deriving exempt dividend income so could not have the necessary nexus to the earning of assessable income. Accordingly it was not deductible.

## **Avoidance**

Even though it had been determined that the guarantee procurement fee was non-deductible Harrison J was still entitled to undertake a tax avoidance analysis on the basis that it would have been contrary to judicial history to bar the arrangement as a whole from being analysed<sup>110</sup>.

## **ii. Arrangement**

Westpac put forward an explanation of the arrangement that was accepted by the Commissioner, except for his addition of the first step being the external borrowing that Westpac undertook. As a result the key elements of the arrangement were as follows<sup>111</sup>:

### Step 1: External Borrowing

On or before 16 September 1998 Westpac approached the international money markets to borrow the equivalent of \$NZ400m in order to fund the transaction.

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<sup>110</sup> Ibid, at 23,879.

<sup>111</sup> Ibid at 23,862.

#### Step 2: KII capitalises KCS

On or before 16 September 1998 KII subscribed new shares in KCS, worth \$US226m.

#### Step 3: Kiwi is incorporated and capitalised

KCS incorporates Kiwi on 10 September 1998 and subscribes 10 common stock shares with voting rights for \$US20m. A further three common share were acquired for \$US6m and 100 non-redeemable preference shares, without voting rights were acquired for \$US200m. The total investment in Kiwi is \$US 226m.

A fixed dividend was required to be paid on the preference shares at a rate of 7.7177% p.a. on \$NZ390m at quarterly intervals commencing on 17 December 1998.

#### Step 4: Promissory Note

Kiwi loaned \$US226m to KII on 15 September 1998. This loan could only have taken place due to Kiwi's capitalisation by KCS. On 16 September 1998 KII issues a promissory note to Kiwi for the amount advanced. Interest was calculated on a floating \$US rate and was sufficient to cover the dividend obligations of Kiwi.

#### Step 5: TBNZ withdraws deposit

\$NZ400m was withdrawn by TBNZ from a money market deposit account that was held with Westpac on or about 14 September 1998.

#### Step 6: TBNZ subscribes for shares in TBNZ Developments Limited

TBNZ acquires \$NZ400m of redeemable preference shares in TBNZ Developments Limited on or about 14 September 1998.

#### Step 7: TBNZ Developments Limited subscribes for redeemable preference shares in TBNZI

TBNZ Developments acquires \$400m of redeemable preference shares in TBNZI on or about 14 September 1998. The only reason for the involvement TBNZ Developments was due a corporate structure previously adopted. It was not tax driven.

#### Step 8: Transfer agreement

Pursuant to a transfer agreement dated 16 September 1998, KCS transferred the preference shares of Kiwi to TBNZI for \$NZ390m. The difference of \$NZ10m was returned to TBNZ by way of redemption of \$NZ10m redeemable preference shares in TBNZI.

#### Step 9: Forward Transfer Agreement

On 16 September 1998 TBNZI agreed to transfer to KCS as follows:

- (1) On the anniversary of the closing date, and with 30 days notice, TBNZI either one half or quarter of the preference shares; and/or
- (2) On 17 September 2003 all preference shares in Kiwi that had not been previously transferred to KCS.

Either party was entitled to terminate the agreement early on the third or fourth anniversary.

#### Step 10: Basis Swap between Westpac and KCS

Westpac and KCS entered in to a basis swap on 16 September 1998 whereby KCS agreed to swap the \$NZ390m it had received for the preference shares in to the equivalent of \$US200m. The basis swap also provided that on the 'final exchange date' that there would be a reverse flow of the principal amount. In addition, on the distribution dates KCS would pay \$US interest to Westpac based on the LIBOR-BBA on the \$US200m, while Westpac would pay \$NZ interest based on a fixed rate of 6.815% p.a., being the five year swap mid-rate, less a 0.14% spread.

#### Step 11: Koch Swap

Kiwi entered into a cross currency interest rate swap with KCS on 16 September 1998. The swap was executed so that the floating \$US interest rate under Kiwi's promissory note could be converted into a fixed \$NZ income stream in order to meet its dividend payment obligations.

#### Step 12: Internal Swap

TBNZI and Westpac entered into a \$NZ interest swap on 16 September 1998 in order to hedge TBNZI's fixed rate dividend income.



#### Step 13: Guarantee Procurement Fee Agreement

On 16 September 1998 an agreement was entered into whereby KCS agreed to obtain a guarantee from KII to the benefit of the Westpac group under KCS obligations in relation to the forward transfer agreement and basis swap. For this TBNZI agreed that on the distribution dated it would pay a fee of 2.85% p.a., based on \$NZ390, to KCS for it procuring a guarantee from KII.

#### Step 14: KII Guarantee

On 16 September 1998 KCS duly obtained a guarantee from KII.

#### Step 15: Toronto-Dominion Letter of Credit

To help support KII's obligations KCS obtained a one year letter of credit for \$NZ195m from the Toronto-Dominion Bank on 16 September 1998. KCS agreed to pay 0.125% being half the fee on the letter of credit. When the letter of credit expired it was not renewed.

#### Step 16: Preference Share Pledge

On September 1998 TBNZI granted KCS a security interest in the Kiwi preference shares in order to secure TBNZI's obligation to transfer shares to KCS under the forward transfer agreement.

#### Step 17: Westpac Guarantee

To secure TBNZI's obligations under the forward transfer agreement and guarantee procurement fee Westpac entered into a guarantee on 16 September 1998. KCS did not pay any consideration for this guarantee.

#### Step 18: Promissory Note

In accordance with the promissory note KII paid interest on each distribution date as required to Kiwi.

#### Step 19: Koch Swap

Based on the \$US LIBOR-BBA Kiwi paid interest on the notional amount of \$US226m on each distribution date. Conversely KCS paid fix \$NZ interest at a rate of 6.815% p.a. on the notional amount of \$NZ441m (this was the equivalent of \$US226m at the

time of entering into the agreement) on each distribution date. This enabled Kiwi to be able to pay the \$NZ dividends.

#### Step 20: Kiwi Dividend

A \$NZ dividend of 7.7177% was paid by Kiwi on each distribution date.

#### Step 21: Internal Swap

A fixed rate \$NZ payment was made to Westpac by TBNZI on each distribution date at a rate of 6.815% p.a., while a floating rate payment was made by Westpac to TBNZI based on the \$NZ-BBR-FRA. The payments made by TBNZI were equivalent to the amount that Westpac was required to pay to KCS due to the basis swap.

#### Step 22: Basis Swap

Westpac, on each of the distribution dates, paid KCS the amount of 6.815% on \$NZ390m. KCS then made the opposite payment of \$US-LIBOR- BBA on \$US200m. The effect of the payments was to hedge the Westpacs position under the internal swap.

#### Step 23: Guarantee Procurement Fee

TBNZI paid to KCS, on each distribution date, an amount of 2.85% p.a., under the guarantee procurement fee agreement, on \$NZ390m and 0.125% on \$NZ195m as a contribution to the letter credit obtained by KCS.

#### Step 24: KCS Letter of Credit Fee

Toronto-Dominion Bank was paid a fee of 0.25% by KCS on each distribution date for the provision of a one year letter of credit. In addition KCS, KIWI and TBNZI entered into a trust agreement whereby KCS would act as agent, receiving all payments and being then required to distribute those payments as required.

#### Step 25: Partial and Final Termination

On 17 September 2000 half of the Kotch transaction was terminated, due to notice being given by TBNZI. To complete the partial termination it was necessary to:

- (1) Have TBNZI transfer 50% of the preference shares to KCS
- (2) Have KCS pay a partial forward transfer price of \$NZ195m to TBNZI

- (3) Terminate and adjust the basis and internal swaps accordingly.

The entire transaction was finally ended on 17 September 2001, due to early notice being given by TBNZI. To complete the early termination it was necessary to:

- (1) Have TBNZI transfer the balance of the preference shares to KCS
- (2) Have KCS pay a partial forward transfer price of \$195m to TBNZI
- (3) Undertake a principal exchange under the basis swap that was then cancelled
- (4) Cancel all other agreements.

For one to be able proceed further with the tax avoidance analysis it is necessary to show that the arrangement had the ‘purpose or effect’ of avoiding tax. To define the term ‘purpose or effect’ Harrison J<sup>112</sup> relied upon *Newton*<sup>113</sup> where it was stated that:

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

This also shows that the extent of a tax avoidance arrangement is determined objectively, based on the legal transactions entered into that give rise to the effect of tax avoidance, and includes all the steps necessary to achieve that effect.

### Purpose

The Commissioner argued that the arrangement had no commercial purpose because it was completely reliant upon the tax benefits arising from it<sup>114</sup>. Harrison J found that this argument not to be correct as the steps in the arrangement created legal obligations between the parties. The funding for the transaction was not circular and real risk was involved<sup>115</sup>. As such one is required to distinguish the commercial purpose of an arrangement from its commerciality or business viability.

It was submitted, based on the history of the transactions earlier proposed, that had the guarantee procurement fee not been included in the Koch transaction that the transaction would not have gone ahead. This along with the fact that the transaction was designed

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<sup>112</sup> Ibid, at 23,880.

<sup>113</sup> *Newton v Federal Commissioners of Taxation*, above n 7.

<sup>114</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,936.

<sup>115</sup> Ibid.

to give rise to exempt dividend income indicated that tax avoidance was at least one of the purposes for which the transaction was entered into<sup>116</sup>.

### Effect

The effect of the arrangement in this instance was that pre-tax losses were converted into after-tax profits.

On this basis Harrison J found that the Commissioner was correct to determine that the arrangement included all steps required to carry the arrangement into effect. This went beyond the legal agreements entered and includes all discussions, negotiations, decisions and correspondence, both internal and external, as to the transaction structure and the implementation steps. Harrison J went on to state that the Commissioner was also correct to include the external funding raised to provide the funds for the transaction. Without the external funding the transaction would not have gone ahead. It was also to be noted that the costs of funds fixed at the current swap rate was an integral part of the dividend rate calculation from which the tax benefits for all parties involved were determined<sup>117</sup>.

### **iii. Tax Avoided**

By entering into the Koch transaction Westpac was able to derive exempt income in the form of dividends received from Kiwi in accordance with section CB10 of the ITA 1994 and at the same time incurred interest expenditure under a financial arrangement that it believed was automatically deductible under section DD1(3) of the ITA 1994. As a result Westpac was able to reduce the amount of tax it paid.

### **iv. More Than Merely Incidental**

Harrison J noted that the definition of tax avoidance, as contained in section OB1, allowed for an arrangement to have multiple purposes or effects. The wording of the

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<sup>116</sup>*Westpac Banking Corporation v The Commissioner of Inland Revenue*, above n 23,948.

<sup>117</sup> *Ibid*, at 23,934.

legislation, he felt, was designed to remove the inconsistent treatment in the treatment of commercial and tax avoidance purposes<sup>118</sup>.

With reference to *Tayles v Commissioner of Inland Revenue*<sup>119</sup>, Harrison J determined that the legislation requires that the tax avoidance purpose or effect to be more than merely incidental<sup>120</sup>. The use of the phrase ‘merely incidental’ emphasised that where a tax avoidance purpose or effect is found to exist it will not automatically infringe upon BG1 if that purpose or effect is ancillary to any commercial or family purpose or effect. Conversely, if there is a commercial or family purpose or effect to an arrangement then one cannot be prevented from pursuing the tax avoidance argument, where that tax avoidance is found to be significant, just because a commercial or family purpose or effect has been identified.

While *Ben Nevis*<sup>121</sup> did not directly consider the ‘not merely incidental’ test their Honours did emphasise that it was necessary to look to the wording of the statutory provisions without inferring one’s own meaning upon the words. The observation made at [114] was found to be pertinent to the current case as it stated that<sup>122</sup>:

...It will rarely be the case that the use of a specific provision in a manner which is outside parliamentary contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental...

To assist in the interpretation of the ‘not merely incidental’ test Harrison J<sup>123</sup> referred to *Europa Oil (NZ) Limited v Commissioner of Inland Revenue*<sup>124</sup>, where at p 556 it was stated that:

... the section in any case does not strike down transaction which do not have as their main purpose or one of their main purposes tax avoidance. It does not strike down ordinary business or commercial transactions which incidentally result in some saving of tax. There may be different ways of carrying out such 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. In such cases the avoidance of tax

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<sup>118</sup> Ibid, at 23,881.

<sup>119</sup> *Tayles v Commissioner of Inland Revenue* [1982] 2 NZLR 726, at 736 (CA).

<sup>120</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,881

<sup>121</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>122</sup> Ibid, at 333.

<sup>123</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,882.

<sup>124</sup> *Europa Oil (NZ) Limited v Commissioner of Inland Revenue* [1976] 1 NZLR 546 (PC).

will be incidental to an not the main purpose of the transaction or transactions  
which will be the achievement of some business or commercial object ...

*Challenge Corporation*<sup>125</sup> was also cited in order to aid in the interpretation process. It was stated that<sup>126</sup>:

As a matter of construction I think the phrase ‘merely incidental purpose or effect’ in the context of s 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.

Harrison J found that the case to which the ‘not merely incidental’ test could apply lay in a spectrum, with those that clearly had tax avoidance as their purpose or effect at one end and those at the other end having a genuine commercial purpose. It was those cases that fell in the middle that caused the most problems, as it was not possible to draw a line in order to determine the correct position. Rather it was necessary to evaluate each case based upon their facts<sup>127</sup>.

In order to determine whether the tax avoidance purpose was more than merely incidental Harrison J focused on the treatment of the guarantee procurement fee<sup>128</sup>. There could have been no objectively ascertainable business purpose for incurring the guarantee procurement fee as Westpac never undertook the normal commercial and prudent evaluation of the fee that one would normally expect to be undertaken for a transaction of such magnitude. In addition the guarantee procurement fee exceed any notion of what could be considered a market value given that expert testimony indicated that the market value should have been around 1% and not the 2.85% that was actually charged<sup>129</sup>.

In addition when claiming the deduction no real economic consequences were incurred as the guarantee procurement fee was built into the dividend formula itself. Commercially there could not be any justification for the Koch transaction as it was never designed to generate a profit. This was because Westpac’s marginal costs were cancelled out by its own cost of funds. Due to the generation of substantial deductions

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<sup>125</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited*, above n 10.

<sup>126</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,882. .

<sup>127</sup> *Ibid*, at 23,883

<sup>128</sup> *Ibid*, at 23,937.

<sup>129</sup> *Ibid*, at 23,913.

enabling the incidence of tax to be altered Harrison J was satisfied that this was the main purpose for entering into the transaction with Koch<sup>130</sup>.

In further evidence put forward by Westpac it was admitted that the primary purpose of the structured finance unit was to enter into transactions in order to minimise the tax payable. As a result the ability of Westpac to offset the loss generated from a transaction against their assessable income dictated whether that transaction proceed. This is not a situation where Westpac was choosing between two different methods of undertaking an economically viable transaction. Westpac entered into these transactions to minimise their tax, not to increase their profits. As a result Harrison J found that tax avoidance was an objective that was pursued in its own right with its purpose being more than merely incidental<sup>131</sup>.

#### **v. Choice Doctrine**

The choice doctrine looks to whether Parliament intended for the tax advantage arising from an arrangement to arise in the manner it did.

Harrison J determined that in addition to the elements previously discussed it was also necessary to show that the parties to the tax avoidance arrangement made use of the specific provisions in a way that was not intended by Parliament<sup>132</sup>. To do so requires one to undertake a wide ranging inquiry that includes an analysis of the provision's use in the light of commercial reality and the transactions economic effect. This principal arose from the case of *Ben Nevis*<sup>133</sup> where it was stated:

When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in light of the arrangement as a whole. If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and

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<sup>130</sup> Ibid, at 23,937.

<sup>131</sup> Ibid, at 23,938.

<sup>132</sup> Ibid, at 23,879.

<sup>133</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3, at 331.

purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement.

...The manner in which the arrangement is carried out will often be an important consideration. So will the role of all relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of the documents and transactions may also be significant. Other features that may be relevant may include the duration of the arrangement and the nature and extent of the financial consequences that it will have for the taxpayer.

...A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way.

...In considering these matters, the courts are not limited to purely legal considerations. They should also consider the use made of the specific provisions in light of the commercial reality and the economic effect of that use.

At the heart of the artificiality of the arrangement was the treatment of the guarantee procurement fee. Westpac, when determining the amount of the guarantee procurement fee, did not undertake a credit analysis of the borrower, nor did it evaluating the shares or any alternative forms of security. As expert witnesses pointed out the guarantee procurement fee was in excess of any possible market value, enabling the both parties to the arrangement were able to derive significant profits as pre-tax losses that were converted into after-tax profits under the arrangement. So from a commercial perspective the transaction did not make sense as the evidence showed that Westpac always intended to make a loss from the transaction.

Economically the transaction made no sense as an equity investment due to the losses that it generated. It was only when one viewed the economic substance of the transaction as a loan that it made sense. It was via the asymmetry in the legislation governing the parties to the arrangement that made the whole process worthwhile.

Further, orthodox economic theory states that it is not possible for an entity with a lower credit rating to lend to a higher rated entity and to be able to derive a profit from that transaction. This is exactly what happened in this transaction. Westpac was borrowing at a margin above LIBOR and then lending those funds to Koch<sup>134</sup>.

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<sup>134</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,930.



In deriving its income from the transaction Westpac did not actually pay the guarantee procurement fee due to it being built in to the dividend rate calculation. Harrison J determined that such a use of a specific deduction provision in conjunction with the ability to derive exempt income in order to provide funding to a party at a rate considerably below market values by returning a share of the tax benefits derived from an expense that was not actually paid could not have been part of Parliament's intention<sup>135</sup>.

As part of the Koch transaction Westpac agreed to pay half of the letter of credit fee that was owed by KCS to the Toronto-Dominion Bank. Commercially it could never be normal practice for one to have to help pay for the expenditure incurred by an unrelated party to a transaction. This add to the overall artificiality of the transaction.

It was put forward that Westpac deliberately manipulated the conduit tax relief rules in order to obtain their tax advantage. Wild J considered this issue in *BNZI*<sup>136</sup> where he concluded that the policy intent behind the provisions was that the New Zealand company would pass on some of the conduit benefits received by means of a dividend to it from a foreign parent that would attract the payment of non-resident withholding tax at 15%. In the current case the transaction entered into were always going to be loss making, with dividends never being paid to the foreign parent. Harrison J determined that Parliament could never have intended for non-resident withholding tax to be avoided in such a manner<sup>137</sup>.

## **vi. Reconstruction**

Once it is determined that an arrangement entered into constitutes tax avoidance section GB1 applies to enable the Commissioner to counteract any tax advantage obtained under that arrangement. The relevant elements of GB1 of the ITA 2004 read as follows:

- (1) Where an arrangement is void in accordance with section BG1, the amounts of gross income, allowable deductions and available net losses included in

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<sup>135</sup> Ibid, at 23,938.

<sup>136</sup> *BNZ Investments Limited & Ors v Commissioner of Inland Revenue* (2009) 24 NZTC 23,582.

<sup>137</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,939.

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.

(1A) Where any amount of gross income or allowable deduction is included in the calculation of taxable income of any person under subsection (1), then, for the purposes of this Act, that amount will not be included in the calculation of the taxable income if any other person.

(2A) Without limiting the generality of the proceeding subsections, if an arrangement is void in accordance with section BG1 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 part the benefit of the credit of tax for any other taxpayer.

Harrison J noted that two principles arose from the application of GB1. The first was that the Commissioner may adjust the amounts of gross income, allowable deductions and available net losses as appropriate when determining a person’s taxable income.

The only concern that may come from this is whether the Commissioner was acting outside his powers when undertaking the reconstruction<sup>138</sup>.

The second principle is that the Commissioner is only able to reconstruct the arrangement so as 'to counteract any tax advantage obtained'<sup>139</sup>. In order to counteract the tax advantage Commissioner is to look to what would have happened but for the arrangement. It is a purely hypothetical scenario, but it is to be based on the information available to the Commissioner at the time of making the reassessment. *Commissioner of Inland Revenue v Canterbury Frozen Meat Co Limited*<sup>140</sup> supports this proposition and observes that the taxpayer has the right to challenge the assessment through the objection procedure. Any information obtained subsequent to the assessment being raised is irrelevant.

It was contended that the Commissioner, before issuing the reassessment, should have undertaken a calculation in order to determine the cost of funding. At the time of making the reassessments the Commissioner was not aware that the funding costs of Westpac were its average deductible cost of funds. In any event Harrison J felt that this could not be held against the Commissioner as he observed that Westpac themselves had admitted that it was beyond their own resources to undertake such a calculation<sup>141</sup>.

#### Commissioner's Reconstruction

The Commissioner submitted that Westpac obtained a tax saving of \$586m from the transactions entered into. To counteract the tax advantage obtained the following expenditure was disallowed<sup>142</sup>:

- The guarantee procurement fee
- The next expenditure on the various swap transactions
- The interest incurred in funding the arrangement.

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<sup>138</sup> Ibid, at 23,940.

<sup>139</sup> Ibid.

<sup>140</sup> *Commissioner of Inland Revenue v Canterbury Frozen Meat Co Limited* [1994] 2 NZLR 681 (CA).

<sup>141</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,941.

<sup>142</sup> Ibid, at 23,943.

Further, the income of Westpac was adjusted to:

- Counteract the reduction of income due to the withdrawal of the deposit
- Reinstate income reduced due to subvention payments and net loss offsets.

Westpac challenged the Commissioner's reconstruction on the following three grounds:

1. That the Commissioner failed to correctly identify the tax advantages obtained by the bank
2. That the cost of funds were incorrectly disallowed
3. That the Commissioner was only entitled to reconstruct the guarantee fee to the extent that the fee was found to exceed an arm's length value.

### *Tax Advantage*

It was put forward by the Commissioner that Westpac derived advantages from the derivation of exempt income and the deductions that were incurred in deriving that income. This included the external funding that was raised on international money markets. Even though the funding of the transaction was not part of the contractual arrangements with the counterparty, the transaction itself would not have proceeded without this funding.

Westpac, however, challenged the Commissioner's assertions by citing *Ben Nevis* where only the licence premium and insurance payments were reconstructed<sup>143</sup>. Third party expenditure was not part of the reconstruction. To do so requires the Commissioner to determine exactly what constituted the tax avoidance, and the elements of that arrangement giving rise to the tax advantage. On this basis Westpac contended that the external funding and the guarantee procurement fee had to be considered separately.

Harrison J found that Westpac's analysis was in error as the legislation only required the Commissioner to counteract the tax advantage found<sup>144</sup>. There was no statutory obligation for the Commissioner to have to identify the elements giving rise to the tax advantage. Further the arrangement is void for tax purposes only and does not have any effect upon the contractual relationships between the parties. The Commissioner was

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<sup>143</sup> Ibid.

<sup>144</sup> Ibid, at 23,944.

correct to include the external funding as part of the arrangement as the arrangement is comprised of all steps required to carry it into effect. Without the external funding the transaction would not have proceeded.

In addition Harrison J saw that there was no requirement for the Commissioner to identify only certain elements of the arrangement that gave rise to the tax advantage. Both the external funding and the guarantee procurement fee were integral elements of the arrangement and would not have arisen if it were not for the arrangement entered into<sup>145</sup>.

### *Cost of Funds*

Westpac argued that the cost of funding was not part of the transactions entered into, nor was the funding sourced from any of the counterparties to the transactions. It was an ordinary incidence of the bank's daily operations and should be deductible in the ordinary course of business. As support for this contention *Commissioner of Inland Revenue v BNZ Investments Limited*<sup>146</sup> was cited by Westpac<sup>147</sup>, where Richard J stated at [56] that:

... a standard commercial RPS investment which in terms of the Income Tax Act entitled BNZ to a deduction for interest on the sums borrowed for investment in the RPS and provided that the dividends on the RPS would be exempt income as inter-company dividends. The RPS investments are a far cry from the self-cancelling and circular schemes that have come before the New Zealand and Australian Courts under the general anti-avoidance provisions.

According to Harrison J<sup>148</sup> Westpac had missed the point, as BNZ Investments limited was not to be part of a tax avoidance arrangement so the reconstruction element did not have to be addressed. On the other hand the Koch transaction was found to be a tax avoidance arrangement. As such the deduction from the external funding was a benefit that arose from the arrangement. The power of the Commissioner was to simply avoid a tax advantage obtained by any of the parties. It was found that the Commissioner's power was exercised in such a manner and did not attempt to go beyond those boundaries.

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<sup>145</sup> Ibid.

<sup>146</sup> *Commissioner of Inland Revenue v BNZ Investments Limited*, above n 62.

<sup>147</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,883.

<sup>148</sup> Ibid, at 23,946.

In the alternative Westpac<sup>149</sup> argued that the disallowance of the funding costs was excessive and if any amount is to be disallowed it is to be limited to the actual deductions claimed. According to Westpac the Commissioner, as previously discussed, should have undertaken a calculation to determine the actual cost of funding, rather than using a proxy.

Harrison J<sup>150</sup> rejected this argument as this information was not within the Commissioner's knowledge at the time of making the assessments. At no point during the disputes process did Westpac inform the Commissioner that the cost of funding was its actual average deductible cost of funds. Although it was argued the amount disallowed was excessive Westpac did not discharge the burden of showing by how much the Commissioner was wrong.

#### *Guarantee Procurement Fee*

Westpac argued that guarantee procurement fee should have been a separately disallowed with the rest of the arrangement remaining intact<sup>151</sup>. Alternatively, if the guarantee procurement was found not to be calculated at a market rate then the Commissioner should have reduced the fee so that it was at a market value in accordance with GD13 of the ITA 2004, which is a specific anti-avoidance provision that deals with cross border transactions<sup>152</sup>.

This argument relied upon the premise that the transaction would have been profitable absent the fee. Although there was an earlier proposal of the Koch transaction that did not include a guarantee procurement fee, no real progress was made until February 1998 when a guarantee fee was introduced. On this basis Harrison J determined that Westpac did discharge its burden of proof as it was found that it could only be speculative on Westpac's part that the transaction would have gone ahead without the guarantee procurement fee being included<sup>153</sup>.

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<sup>149</sup> Ibid.

<sup>150</sup> Ibid.

<sup>151</sup> Ibid, at 23,947.

<sup>152</sup> Ibid.

<sup>153</sup> Ibid, at 23,948.

Westpac<sup>154</sup> also attempted to rely upon *Europa Oil (NZ) Limited v Commissioner of Inland Revenue*<sup>155</sup> where at p 570 it was stated that:

The Commissioner should instead have disallowed so much (if any) of the objector's fob costs in each year as exceeded the actual arm's length long term market values of the feedstocks in respect of which such costs were incurred.

Harrison J found this case to be of no assistance to Westpac as it dealt with a specific deductibility provision<sup>156</sup>. It did not provide authority that the general anti-avoidance provision does not apply to the extent that the deduction was at an arm's length value.

Westpac also relied upon the opinion of an expert witness to show that the true market value of the guarantee procurement fee was 1% and not 2.85% as originally claimed. During the disputes process Westpac should have established the correct amount by which the guarantee procurement fee was deductible. It did not. The Commissioner in undertaking his assessment was unable to undertake the calculation proposed by Westpac as that information had not been provided to the Commissioner<sup>157</sup>.

Furthermore, Westpac's argument was contrary to section GB1<sup>158</sup>. The section did not require that all a partial deduction based on a hypothetical scenario as to what might have happened if the guarantee procurement fee was at a market rate.

## **vii. Conclusion**

Harrison J's analysis of Westpac's challenge to the Commissioner's reassessment was to confirm the reassessment as Westpac failed to show that the Commissioner was in error and by how much he was in error.

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<sup>154</sup> Ibid, at 23,947.

<sup>155</sup> *Europa Oil (NZ) Limited v Commissioner of Inland Revenue* [1976] 1 NZLR 563, at 570 (PC).

<sup>156</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2, at 23,948.

<sup>157</sup> Ibid, at 23,949.

<sup>158</sup> Ibid, at 23,949.

### **c. Commissioner of Inland Revenue v Penny and Hooper<sup>159</sup>**

This case involves the restructuring of the business affairs of two orthopaedic surgeons, each operating under their own name. The terms of this agreement was recorded in a Deed of Management. While there are similarities in the new structures adopted by the surgeons there are sufficient differences that require each of the structures to be explained separately.

Mr Hooper started practising privately as a surgeon in 1989 in shared facilities with other orthopaedic surgeons, while at the same remaining employed by the Canterbury District Health Board. In 1991 Mr Hooper and his wife established family trusts. Each of the trusts had their accountant and solicitor as trustees. The beneficiaries were the spouse, children and grandchildren. The purpose for establishing the trusts was so that they could each acquire a half share of Mr Hooper's interest in the orthopaedic centre from which he operated.

During 2000 the business affairs of Mr Hooper were restructured, starting with the incorporation of Hooper Orthopaedic Limited ("HOL"). 99% of the shares were equally owned by the two trusts and Mr and Mrs Hooper held the remaining 1% in their personal capacity. The purchase price was \$332,473. This was funded via vendor fiancé provided by Mr Hooper. This amount has yet to be repaid. After the restructuring Mr Hooper became an employee of HOL, with HOL taking over Mr Hooper's role in the orthopaedic centre. Despite the restructuring Mr Hooper continued to perform surgeries for the Canterbury District Health Board. The only difference was that the income that Mr Hooper would have earned previously was now the income of HOL.

In the income years ended 31 March 1999 and 31 March 2000 Mr Hooper's net profit was approximately \$650,000. For the income years ended 31 March 2001 to 31 March 2004 Mr Hooper derived a salary of \$120,000 p.a. from HOL.

The retained earnings of HOL were never received by Mr and Mrs Hooper in any form. Rather, those earnings were invested in bank deposits and the family and holiday homes

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<sup>159</sup> *Commissioner of Inland Revenue v Penny and Hooper* (2010) 24 NZTC 24,287 (CA) [Penny and Hooper].



of Mr and Mrs Hooper. Mr Hooper continued to return the salary received from the Canterbury District Health Board in his own capacity.

The reason given by Mr Hooper for adopting such a structure was to avoid being sued for medical negligence and he was aware of the fact that other surgeons had transferred their practices into a trust structure. Mr Hooper was also looking for options for the trusts to create more income. After discussions with his accountant the company structure was chosen. Mr Hooper acknowledged that he was aware of the change in the personal tax rates at the time.

When determining the salary of \$120,000 to be paid Mr Hooper based that figure on the public hospital scale with a multiplier of 1.4. Commercially, Mr Hooper said that he would never expect such a salary if he was to be employed by any other company.

Mr Penny adopted a similar structure to that of Mr Hooper, but several years earlier. From 1989 Mr Penny worked for the Canterbury District Health Board, but commenced his private practice in 1991 in his own name. In 1997 Penny Orthopaedic Services Limited (“POSL”) and Orthopaedic Surgical Consultancy Limited (“OSCL”) were incorporated. Mr Penny was the sole shareholder of POSL while the AC Penny No 1 Trust was the sole shareholder of OSCL, which was established at the same time.

The practice was transferred to POS for \$144,310, with Mr Penny becoming an employee. Two months later the practice was on-sold to OSCL for \$1,044,310, generating a capital profit that was then distributed to Mr Penny. It was understood that Mr Penny’s employment contract would also be transferred as part of the deal, although there was no written evidence to support such a transfer.

Mr Penny, after the restructuring, continued to practice exactly as before. Again, just like Mr Hooper, the income derived from private patients was attributable to a company; in this case being OSCL.

From the income year ended 31 March 2000 onwards Mr Penny’s salary dropped from \$302,000 to \$125,000. After this Mr Penny’s salary remained at under \$100,000. In Mr Penny’s defence it was put that an exceptional profit was derived in the income year ended 31 March 1999.

Mr Penny also had concerns about being sued for medical negligence and wanted to adopt a structure that would best protect his assets. He further acknowledged that the salary being paid was commercially unrealistic.

Before going into a detailed analysis as to whether a tax avoidance arrangement existed Randerson J undertook a review of the principals arising from the *Ben Nevis*<sup>160</sup> case. From this he found that the Supreme Court had decided that<sup>161</sup>:

1. the reconciliation of specific and general anti-avoidance provisions requires a ‘principled approach which gives proper overall effect to statutory language that expresses legislative policies’;
2. decisions on individual case were to be made through ‘the application of a process of statutory construction focusing objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisers have set up’;
3. the specific tax provisions and the general anti-avoidance provisions are to construed together so as to give appropriate effect to each; and
4. whether an arrangement constitutes tax avoidance will depend on whether the taxpayer’s use of the specific statutory provision has occurred in a manner that is consistent with Parliament’s purpose, determined by an objective analysis of the overall scheme and purpose of the Act.”

### **i. Arrangement**

It was considered by Randerson J that the expression of “arrangement” was to be defined very broadly so as to embrace all steps and transaction by which the arrangement is carried into effect.

This position was reinforced by Randerson J where he said that<sup>162</sup>:

I am satisfied that an ‘arrangement’ is not limited to a specific transaction or agreement but may embrace a series of decisions and steps taken which together evidence and constitute an agreement, plan or understanding. Any such agreement may be continued in each of the income years in question or may be varied from year to year.

This meant that the scope of the arrangement was not to be determined based on the one transaction or contract entered into. Rather it was to be determined by looking to the

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<sup>160</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>161</sup> *Ibid*, at 24,298.

<sup>162</sup> *Ibid*, at 24,302.

effect that was to be achieved, and the steps required to give life to that effect. Further it meant that an arrangement could exist only in one income year, could span multiple income years, or could be acceptable in one year but not the next.

The Commissioner put forward the following four step arrangement<sup>163</sup>:

1. The decisions of the taxpayers in the relevant income years to operate their private practices through the company and family trust structures;
2. And the individual taxpayers to pay the respondents a salary that was substantially less than a commercially realistic salary;
3. Channelling the company profits to the trust and allowing the taxpayers to have the benefit of those funds without deriving such funds as their personal income; and
4. In Mr Penny's case, the decision to advance funds to him from the trust which enabled him to access those funds for his personal benefit.

Randerson J did not accept the full arrangement as put forward by the Commissioner due to the evidence exclusion rule contained in section 138G of the Tax Administration Act 1994 ("the TAA 1994) prohibiting the Commissioner from expanding upon the arrangement as originally contained in the Commissioner's Statement of Position. This meant that the Commissioner was unable to expand upon the arrangement and argue that the loan given to Mr Penny formed part of the arrangement. This resulted in Randerson J accepting the first three steps as being the elements that constituted the arrangement in question<sup>164</sup>.

In deciding to accept the Commissioner's version of the arrangement, as defined in his Statement of Position, Randerson J<sup>165</sup> considered that the decisions made in relation to the establishment of the company/trust structures and the decision as to the amount of salary, dividends and cashflows coming out of that structure amounted to an 'arrangement' as defined by the legislation as these were all steps required to enable Mr Penny and Mr Hooper to achieve their desired tax saving goal. To come to this

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<sup>163</sup> Ibid, at 24,300.

<sup>164</sup> Ibid, at 24,303.

<sup>165</sup> Ibid, at 24,301.

conclusion it was necessary for Randerson J to determine the purpose or effect of the arrangement.

## **ii. Purpose or Effect of the Arrangement**

According to the Commissioner's submissions<sup>166</sup> it was clear that one of the effects of the arrangement was tax avoidance as it took advantage of the difference in the top marginal personal tax rate of 39% and the company tax rate of 33% by allocating an artificially reduced salary to each of the individuals.

On the other hand it was put forward that the use of the structure adopted took advantage of an entitlement provided by Parliament and was a legitimate means by which one could choose to operate a business. In addition there were only limited circumstances upon the legislation allowed for the alteration of a taxpayer's salary, and those cases involved instances of an excessive salary being paid to a spouse or relative when the services provided did not equate to that salary. Personal services attribution rules were introduced at the same time as the change in tax rates to deal with situations where a company is effectively earning its income from one source. As it was submitted that those rules did not apply to the companies in question then there was no basis for attributing the income of the companies to the individuals involved<sup>167</sup>.

To determine the correct position Randerson J<sup>168</sup> relied upon the decision of *Ben Nevis*<sup>169</sup> as it mandated a two stage inquiry. Under the first limb it is first necessary to determine whether that if it were not for the anti-avoidance provisions that the taxpayers would have been free to adopt the trading structure they did. The second limb requires that consideration be given as to whether the taxpayers use of the specific provisions fell within the scope intended by Parliament, by looking to the scheme and purpose of the Act.

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<sup>166</sup> Ibid, at 24,291.

<sup>167</sup> Ibid, at 24,303.

<sup>168</sup> Ibid.

<sup>169</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3, at 331.

The first limb was very easy to analyse as it was obvious from the way the legislation was worded that taxpayers always had the option to operate through a company structure if they so desired. It would then turn upon how that structure was utilised as to whether the arrangement had as at least one of its purposes or effects the purpose or effect of tax avoidance. This necessitated inquiry under the second limb of the test.

To undertake the analysis of the second limb Randerson J<sup>170</sup> firstly looked to the personal services attribution rules. The purpose of the rules was to counter any tax benefits arising from situations where a company is utilised to derive income from predominately one source in circumstances where the company is not truly operating an independent business. According to the Commentary on the Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill 2000 the rule was designed to attribute income that in substance was employment income to the shareholder of the company. The timing of the introduction of the rules indicated that Parliament always wanted to differentiate between those companies caught by the rules and those that were not.

### **iii. More Than Merely Incidental Purpose or effect of Tax Avoidance**

When coming to the conclusion that the arrangements entered into by Mr Penny and Mr Hooper had a more than merely incidental purpose or effect of tax avoidance Randerson J again relied upon the decision of *Ben Nevis*<sup>171</sup> as the case made it clear that even though taxpayers may have adopted a legitimate structure by which to operate that this would not prohibit a finding of tax avoidance in circumstances where the arrangement entered into generates a tax advantage outside the means intended by Parliament. This conclusion is supported by a significant number of cases such as *Commissioner of Inland Revenue v Auckland Harbour Board*<sup>172</sup> and *Miller*<sup>173</sup> Randerson J<sup>174</sup> then went

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<sup>170</sup> *Commissioner of Inland Revenue v Penny and Hooper*, above n 159, at 24,303.

<sup>171</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>172</sup> *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (CA) [Auckland Harbour Board].

<sup>173</sup> *Miller*, above n 13.

<sup>174</sup> *Commissioner of Inland Revenue v Penny and Hooper*, above n 24,307.

onto specifically quote *Commissioner of Inland Revenue v BNZI*<sup>175</sup> where it was stated that:

Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways; that tax is an important and proper factor in business decision making and family property planning; that something more than the existence of a tax benefit in one hypothetical situation compared with another is required to justify attributing a greater tax liability; that what should reasonably be struck at are the artifices and other arrangements which have tax induced features outside the range of acceptable practice – as Lord Templeman put it in *Challenge* at p 562, most tax avoidance involves a pretence; and that certainty and predictability are important but not absolute values.

From a review of the facts of the case *Randerson J*<sup>176</sup> found that there were two main features that indicated that the tax benefits derived from the arrangements was more than merely incidental. The first one was that both parties were originally operating their practices under their own name, but had some point had chosen to adopt a trust and company structure from which to operate the same businesses. Although, by itself, this was not enough to enable a finding of tax avoidance, it was the second feature, being the significant reduction in salaries received, that enabled a determination that the tax benefit was more than merely incidental. This was especially the case given that the salaries were reduced for the income years ended 31 March 2001 and subsequent, coinciding with an increase in the top marginal personal tax rate to 39%. For Mr Hooper his salary was reduced from approximately \$650,000 to \$120,000, while Mr Penny's salary was reduced from \$302,000 to \$125,000. Throughout their evidence Mr Penny and Mr Hooper acknowledged that they would not have accepted such salaries if they were offered by a third party.

There was no commercial reason for the salaries paid to be reduced by such an amount. The practices operated by Mr Hooper and Mr Penny did not need additional capital nor were there insufficient profits from which to pay a proper salary. In fact Mr Penny and Mr Hooper continued to work within their respective practices just as they had done so before<sup>177</sup>.

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<sup>175</sup> *Commissioner of Inland Revenue v BNZ Investments Limited*, above n 60 ,at 463.

<sup>176</sup> *Commissioner of Inland Revenue v Penny and Hooper*, above n 159.

<sup>177</sup> *Ibid*, at 24,308.

It was then necessary for Randerson J<sup>178</sup> to consider the treatment of the increased company profits due to the reduced salaries. The profits of the companies were transferred to the respective family trusts in their capacity as shareholders. In addition Mr Penny received loans of over \$2 million, which unsecured and had no terms of repayments, via the family trust. The end effect was that Mr Penny and Mr Hooper were still able to benefit from the income derived by their companies, but at the same time were able to significantly reduce the amount of tax paid on that income. This showed that the tax benefits arising from the arrangements entered into were more than merely incidental.

While it had been put forward that one of the major reasons for adopting this particular structure was to provide financial security for the respective families, Randerson J felt this could have just as easily been achieved by the application of the salaries received to that purpose. Nor could the idea that the structure was designed to prevent any potential negligence claims from falling upon the individuals as the ACC legislation limits such action and that in any event a company structure could not void such liability<sup>179</sup>.

#### **iv. Choice Doctrine**

As part of the Commissioner's submissions reference was made to the case of *Hadlee v Commissioner of Inland Revenue*<sup>180</sup>. As previously discussed this case dealt with a situation whereby a partner or an accountancy firm assigned a proportion of his partnership income to a family trust that comprised his wife and children as beneficiaries. In a dissenting judgment Ellen France J<sup>181</sup> determined that the *Hadlee*<sup>182</sup> case could not apply as it dealt with the assignment of income while the present case dealt with the derivation of income.

Randerson J<sup>183</sup> looked to the significance of the case as an aid to determining the purpose or effect of the arrangement despite this, because both cases dealt with a

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<sup>178</sup> Ibid.

<sup>179</sup> Ibid.

<sup>180</sup> *Hadlee v Commissioner of Inland Revenue* [1993] 2 NZLR 385 (PC).

<sup>181</sup> *Commissioner of Inland Revenue v Penny and Hooper*, above n 159, at 24,316.

<sup>182</sup> *Hadlee v Commissioner of Inland Revenue*, above n 181.

<sup>183</sup> *Commissioner of Inland Revenue v Penny and Hooper*, above n 159, at 24,306

situation where income moved out the hands of those that exerted the effort to derive the income in the first instance.

It was acknowledged that the *Hadlee*<sup>184</sup> case was distinguishable from that of the present case on the basis that the income was derived by the respective companies of Mr Penny and Mr Hooper. But the case did raise issues that aligned with the present case. In particular it was concluded that the income tax legislation required salary and wage earners to pay tax on the income they earned, with applying equally to the income derived by self-employed people. Further the adoption of a structure by which the income derived from, personal exertion could be diverted to another party in means that enabled higher marginal tax rates to be avoided was found to be a signpost that indicated that there was a possibility that the arrangement did not fall within Parliament's intention.

In addition the *Hadlee*<sup>185</sup> case had factual similarities, especially when one analysed the commerciality of the arrangement entered into. The key similarity was the fact that although a significant proportion of the income earned by Mr Hadlee from the accountancy partnership, being 40%, was assigned to a family trust, he was still able to take advantage of the full income from that trust. In addition the tax liability on the total income derived from the accountancy partnership was significantly reduced<sup>186</sup>.

According to Randerson J it was necessary to assess all the circumstances including the extent and nature of any element of artificiality or contrivance in order to determine whether the arrangement in question was applying the specific provisions of the Act as intended by Parliament. Further facts beyond the artificially low salaries paid, such valuation of the goodwill upon the establishment of the companies being nowhere near the salaries previous derived by Mr Penny and Mr Hooper in their individual capacities, indicated the artificial nature of the arrangements entered into.

Ultimately Randerson J<sup>187</sup> concluded that it could not have been Parliament's intention to enable a person to derive an artificially low salary in circumstances where they were still able to get the full benefit of the income earned by the entity that employed them

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<sup>184</sup> *Hadlee v Commissioner of Inland Revenue*, above n 181.

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

<sup>186</sup> *Commissioner of Inland Revenue v Penny and Hooper*, above n 159, at 24,306.

<sup>187</sup> *Ibid.*, at 24,309.



and at the same time have a significantly reduced tax liability on the total income to which the person had the benefit of.

#### **v. Reconstruction**

From the analysis of the artificiality of the arrangements entered into by Mr Penny and Mr Hooper the focus largely centred around a comparison between the salaries paid before and after the arrangements were executed. Despite establishing that the salaries paid to Mr Penny and Mr Hooper were artificially low there were no attempts by Randerson J to quantify the salaries that should have been attributed to them. Rather, it was left for the Commissioner to determine the appropriate salary upon which Mr Penny and Mr Hooper should have respectively paid tax upon. Leave to apply was given to the parties in case there were questions arising as a result of the reconstruction.

Randerson J was aware of the consequences and problems that arose from this decision when he stated that<sup>188</sup>:

I am conscious of the practical consequences which may flow from this decision, including the uncertainty which maybe created for the Commissioner as well as for taxpayers and their advisers. To what extent and in what circumstances will it be necessary to review the salary levels of employees (particularly in family companies) to determine on which side of the line their salary may fall? It is important to recognise, however, that this decision should not be regarded as establishing a principle that salary levels in family companies which are below the levels which could be expected in an arms-length situation, are necessarily to be regarded, without more, as evidence of a tax avoidance arrangement.

#### **vi. On Appeal**

The current case is on appeal with the Supreme Court. Therefore the final decision on the matter has yet to be determined. As the High Court in *Penny v Commissioner of Inland Revenue; Hooper v Commissioner of Inland Revenue*<sup>189</sup> decided against the Commissioner there is less certainty of win for the Commissioner. Had this decision

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<sup>188</sup> Ibid.

<sup>189</sup> *Penny v Commissioner of Inland Revenue; Hooper v Commissioner of Inland Revenue* (2009) 24 NZTC 23,406 (HC).

been released prior to the finalisation of this paper it would have been included as it would have provided a useful conclusion as to the judiciaries' position on the anti-avoidance provisions.

#### **d. *Krukziener v Commissioner of Inland Revenue*<sup>190</sup>**

The taxpayer was a property developer, who, based on his own description, was quite successful. Each property development project undertaken was usually undertaken by a special purpose entity, being a trust with a corporate trustee. The taxpayer would then be the shareholder and director of that corporate trustee. Despite the taxpayer claiming that all but one of his property development projects were successful there was generally no salary paid to him.

To fund his day-to-day living costs regular drawings were made from the entities that he controlled. These transactions were recorded in various current accounts in the name of the taxpayer in each of the relevant entities. For the period of 1 April 1991 to 31 March 2002 the current account drawings amounted to \$5,094,442, after taking into account any repayments that may have been made by the taxpayer. The majority of the repayments were affected by book entries. As a result of these drawings the taxpayer only paid income tax totalling \$27,324.22, of which \$8,478.45 was refunded to him.

These drawings were treated as loans by the taxpayer accountants, with the taxpayer contending that the drawings represented an advance on the future expected profits of a project. From the taxpayer's perceptive it was expected that these loans would be repaid from capital or tax paid distributions. In August 2002, soon after the period in question, a large bulk of the remaining indebtedness owing by the taxpayer was settled via a capital profit distribution of \$3,66,146.457 that arose from the sale of a commercial property due to the financial pressures that arose from the failed project.

Although the drawings were being treated as loans there were no specific terms, either verbally or in writing, as to the how and when the loans were to be repaid, and nor was there any interest charged. There was no evidence provided to show that demand was

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<sup>190</sup> *Krukziener v Commissioner of Inland Revenue* (2010) 24 NZTC 24,563 (HC) [Krukziener].

being made for the loans to be repaid, even though there were instances of companies being put into liquidation due to their inability to pay their debts as they fell due. Ultimately the taxpayer controlled when and how any repayments would be made as he controlled both the lenders and the entities from which the capital distributions arose.

### **i. Arrangement**

When defining the term ‘arrangement’ P Courtney J placed reliance upon the definition contained in the case of *AMP Life v Commissioner of Inland Revenue*<sup>191</sup>. The decision in *AMP Life*<sup>192</sup> followed the legislative definition of ‘arrangement’ by referring to it as “a contract, agreement, plan or understanding.”

McGechan J, in *AMP Life*<sup>193</sup>, further expanded upon this definition by stating that the concepts required that events constituting an arrangement were required to have some prior planning or sequencing or both. This meant that from the beginning to the end of the arrangement that it was necessary to show that each of the steps was designed to achieve a predetermined end in order for those events to be brought under the definition of the word arrangement.

After reviewing the submissions put forward by each of the parties P Courtney J<sup>194</sup> considered that an arrangement did exist as he stated that:

Looking back over the relevant period, there emerges a pattern of substantial advances in respect of which only sporadic repayments were made, seemingly at the will of Mr Krukziener and apparently, coinciding with the availability of non-taxable capital distributions. The ever increasing level of advances, coupled with the relative lack of repayments over a long period of time, suggests a deliberate plan that there would be no requirement for Mr Krukziener to repay the advances unless and there was a capital distribution available to apply for that purpose.

It was put forward on behalf of the appellant that one’s annual income tax liability was determined on a year by year basis<sup>195</sup>. As a result there could not be an arrangement because all that existed at the end of each year was the drawings taken, with repayments

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<sup>191</sup> *AMP Life v Commissioner of Inland Revenue* (2000) 19 NZTC 15,940 (HC) [AMP Life].

<sup>192</sup> Ibid.

<sup>193</sup> Ibid, at 15,957

<sup>194</sup> *Krukziener v Commissioner of Inland Revenue*, above n 191, at 24,568.

<sup>195</sup> Ibid, at 24,569.

to come from some future source of funds. This analysis could not change the decision that there was an arrangement because at year the outstanding balance owing the appellant was recorded in the financial statements of the entity from which the funds were drawn. All this analysis helps to confirm is that there was an arrangement for each of the years under consideration.

This resulted in P Courtney J accepting the arrangement as put forward by the Commissioner. The Commissioner determined that the arrangement comprised the following steps<sup>196</sup>:

- a) Mr Krukziener borrowed funds from the Felix Trust, KPL and other associated entities;
- b) There was no defined date for repayment or interest payable (except for the debt to KPL in 2001–2002);
- c) No (or only slight, depending on the income year) taxable distributions or amounts were paid by the associated entities/trusts to Mr Krukziener, with repayments of the loans being made from non-taxable distributions received from associated entities.”

“Mr Krukziener borrowing funds from the various entities that he was associated with; There being no defined terms for the advances given. In particular there was no repayment schedule or interest imposed (although advances from one entity for the income years ended 31 March 2001 and 31 March 2002 were an exception); Minimal taxable distributions were made to Mr Krukziener. Any repayments of the loans came from non-taxable distributions received from the entities that he was associated with.

### *Tax Advantage*

From the facts of the case it was clear that the arrangement entered into placed the taxpayer in a position whereby had he received the funds in another form that they would have been assessable for income tax in his hands. The advancing of the funds via loans enable this liability to be avoided. This enabled the taxpayer to receive net funds of \$5 million upon which no tax was payable.

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<sup>196</sup> Ibid, at 24,566.

## ii. Purpose and Effect of the Arrangement

The purpose or effect of the arrangement was determined based on the analysis contained in the case of *Ben Nevis*<sup>197</sup>. This required a determination as to whether the use of specific provisions of the legislation were in line with Parliamentary intention. This meant that the specific provisions of the Act were required to act in tandem with the anti-avoidance provisions. To read the legislation any other way would make the anti-avoidance provisions impotent. Obviously if a provision was being used outside its intended scope then there would be an element of tax avoidance. If a specific provision was being applied as intended by Parliament then further inquiry would be required<sup>198</sup>.

In undertaking this further inquiry P Courtney J<sup>199</sup> made reference to the two stage inquiry contained in para 107 and the various tests contained in para 108 in the judgment of *Ben Nevis*<sup>200</sup>. In addition the decision of *Glenharrow Holdings Limited v Commissioner of Inland Revenue*<sup>201</sup> was used assist as it made reference to the *Newton*<sup>202</sup> decision. In particular para 37 and 38 of that decision were referred to. In those paragraphs it was stated that:

In *Newton v Commissioner of Taxation of the Commonwealth of Australia*, in giving the advice of the judicial committee, Lord Denning said that in the phrase ‘purpose or effect’ in the Australian general anti-avoidance provision of that time the word ‘purpose’ meant not motive but the effect that was sought to achieve – the end in view. The word ‘effect’ meant the end accomplished or achieved. It was necessary, his Lordship said, to look at the arrangement itself and see its effect irrespective of the motives of the person who made it.

What Lord Denning was emphasising was that the general anti-avoidance provision was concerned not with the purpose of the parties, but with the purpose of the arrangement. That is a crucial distinction. Once you have put the purpose of the parties to one side and seek by objective examination to find the purpose of the arrangement, you must necessarily do that by considering the effect of which the arrangement has had – what it has achieved – and then, by working backwards as it were from the effect, you are able to determine what objectively the arrangement must be taken to have as its purpose. That approach is inevitable once any subjective purpose or motive is ruled out of contention.”

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<sup>197</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>198</sup> *Krukziener v Commissioner of Inland Revenue*, above n 191, at 24,569.

<sup>199</sup> *Ibid*, 24,570.

<sup>200</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>201</sup> *Glenharrow Holdings Limited v Commissioner of Inland Revenue* [2008] NZSC 116.

<sup>202</sup> *Newton v Federal Commissioners of Taxation*, above n 7.

The taxpayer contended that the specific provisions being applied were within Parliament's intention and that there was in fact a commercial rationale for the arrangement<sup>203</sup>. It was these questions to which the above analysis had to be applied, in order to come to the conclusion as to whether or not the arrangement entered into had the purpose or effect of tax avoidance.

To counter this analysis it was submitted that there was no requirement that a taxpayer even take a salary. Reliance was placed upon *Penny v Commissioner of Inland Revenue; Hooper v Commissioner of Inland Revenue*<sup>204</sup> in order to further this argument. Subsequent to this submission being made the appeal case was decided<sup>205</sup>. As discussed earlier it was determined that the restructuring of the taxpayers' businesses resulted in a significant drop in the salaries being returned. This led to the conclusion that the arrangement entered into had tax avoidance as its effect and for at least one of its purposes, but it was not to be construed that in all cases where the salary was less than market value that it was tax avoidance unless there was further evidence in support of that proposition. These arguments enable the taxpayer's assertions, that there could be justifiable reasons for paying a reduced or even no salary while waiting for a project to be completed, to stand. Given the circumstances of the current case P Courtney J raised the question as to why the taxpayer would have gone for such a long period of time without receiving any income.

### **iii. More Than Merely Incidental Purpose or effect of Tax Avoidance**

It was submitted on behalf of the taxpayer that living off capital was a normal and not at all uncommon, sighting examples such as using revolving credit to pay for holidays or living expenses, or downsizing one's home and living off the proceeds. Following this there was an attempt to show that the arrangement had a commercial rationale, firstly by arguing that the Commissioner did not argue that the transactions entered were a sham and secondly that there were no profits to distribute during the years in question<sup>206</sup>.

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<sup>203</sup> *Krukziener v Commissioner of Inland Revenue*, above n 191, at 24,571

<sup>204</sup> *Penny v Commissioner of Inland Revenue; Hooper v Commissioner of Inland Revenue*, above n 190.

<sup>205</sup> *Commissioner of Inland Revenue v Penny*, above n 159.

<sup>206</sup> *Krukziener v Commissioner of Inland Revenue*, above n 191, at 24,573

On the first point P Courtney J<sup>207</sup> held that by itself the existence of a genuine transaction does not prove the existence of a commercial rationale, as genuine transactions can be part of a tax avoidance arrangement. For the second it found that this argument was contrary to the evidence put forward that the majority of projects undertaken by the taxpayer had been profitable. In addition P Courtney J could not support the underlying theme of the evidence given in support of the taxpayer that a significant tax liability was to come from a project that was intended to be the taxpayer's final project. This was because the advances from another entity pre-dated this project and been outstanding for a number of years and it was this project that caused the then accountant to cease all involvement with the taxpayer.

No commercial rationale could be found for the arrangement. Leaving the taxpayer in debt was supposed to be a defensive strategy. P Courtney J<sup>208</sup> could not place much weight on this argument as one of the entities made a significant capital profit distribution at time when the group of entities controlled by the taxpayer was in financial difficulty. In addition leaving the taxpayer in debt opened him up for liability should the entity from which the funds were advanced go into liquidation.

From a practical point of view it made no sense for the group to have to borrow at commercial interest rates and to advance some of those funds to the taxpayer on interest-free terms, especially when entities within the group generated profits that may have been distributed but chose not to. This is even more exacerbated by the fact that despite the group meeting the cost of this funding that there never was any demand for repayment of the advances despite the significant amount of funds received<sup>209</sup>.

Against all of these facts the tax benefit of the arrangement came to the fore, above any other benefit that may have been purported. The reality was that the taxpayer had received net advances of \$5 million with repayments coming from capital receipts upon which no tax was payable. It was clear given the way that the group was structured that there never was any intention for any tax to be paid either by the entities or the taxpayer himself.

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<sup>207</sup> Ibid.

<sup>208</sup> Ibid, 25,574.

<sup>209</sup> Ibid.

#### iv. Choice Doctrine

The taxpayer<sup>210</sup> contended that reality of the situation was that he was in receipt of loans that did not bear any income tax implications. Money could only be considered to be income in the hands of the recipient only when they definitely became entitled to those funds. Loans on the other hand require repayment at some point in the future so the borrower can never be definitely entitled to the funds. Reliance was placed upon *Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation*<sup>211</sup>, where it made reference to *Carden's case*<sup>212</sup> in which it was stated that:

... in the assessment of income the objective is to discover what gains have during the period of account come home to the taxpayer in a realised or immediately realisable form (1936) 63 CLR at p155. The word 'gains' is not here used in the sense of the net profits of the business, for the topic under discussion here is assessable income, that is to say gross income. But neither is it synonymous with 'receipts'. It refers to amounts which have not only been received but have 'come home' to the taxpayer; and that must surely involve, if the word 'income' is to convey the notion it expresses in the practical affairs of business life, not only that the amounts received are unaffected by legal restrictions, as by reason of a trust or change in favour of the payer – not only that they have been received beneficially – but that the situation has been reached in which they may properly be counted as gains completely made, so there is neither legal or business unsoundness in regarding them without qualification as income derived. ...

In addition it was submitted that the transactions in question followed generally accepted accounting practices, with loans being recorded as an asset by the lender and the corresponding obligation to make repayments being recorded as a liability.

It was on the basis of these arguments that the taxpayer concluded that the arrangement entered into by the taxpayer made legitimate use of the specific provisions of the Act, and in doing so were within the scope intended by parliament.

Given that the tax advantage arising from the arrangement was so dominant to the underlying reason for the implementation of the scheme P Courtney J<sup>213</sup> could not come to the conclusion that the use of the specific provisions was within the scope intended

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<sup>210</sup> *Krukziener v Commissioner of Inland Revenue*, above n 191, at 24,572.

<sup>211</sup> *Arthur Murray (NSW) Pty Ltd v Federal Commissioner of Taxation* (1965) 114 CLR 314 (HCA).

<sup>212</sup> *The Commissioner of Taxes (South Australia) v The Executor Trustee and Agency Company of South Australia Limited* (1938) 63 CLR 108.

<sup>213</sup> *Krukziener v Commissioner of Inland Revenue*, above n 191, at 24,575.



by Parliament. In any event, even if the use of the specific provisions did come within Parliament's intention the Commissioner was not prevented from undertaking a tax avoidance analysis<sup>214</sup>, with P Courtney J accepting the conclusion that the arrangement did have the purpose or effect of tax avoidance.

#### **v. Reconstruction**

The issue of reconstruction was not directly dealt with in the judgment. From the facts of the case it is obvious that if it were not for the arrangement the funds received by the taxpayer would have been assessable income as they would have been received in some other form. This meant that there was no need for P Courtney J to go into any form of analysis to explain how the tax advantage obtained should be countered by the Commissioner. In fact the driving issue of the case was whether or not the funds received by the taxpayer, by way of loans, was in substitution for income.

#### **e. Was *Elmiger* Correctly Applied?**

It is the writer's opinion that each of the cases analysed has been correctly decided, with the legal principles of *Elmiger*<sup>215</sup> being applied as Parliament intended. Each of the cases showed the application of the five steps as outlined in the statutory framework, in accordance with their correct interpretation. Although *Ben Nevis*<sup>216</sup> did not strictly adhere to the five step analysis in an orthodox sense, one can tell from the two step inquiry that it was still necessary for each step of the statutory framework to be part of the underlying inquiry. To do otherwise would have meant that the inquiry was incomplete.

Despite Harrison J, in *Westpac*<sup>217</sup>, consolidating the judicial learnings of *Ben Nevis*<sup>218</sup> into the judgement, *Westpac*<sup>219</sup>, in the writer's opinion, does not appear to be the settled approach to tax avoidance in New Zealand. There appear to be three main reasons for

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<sup>214</sup> Ibid, at 24,570.

<sup>215</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>216</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>217</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2.

<sup>218</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>219</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2.

this result. Firstly, when one looks at the subsequent case law in this field it can be seen that the decisions make reference to *Ben Nevis*<sup>220</sup> rather than to *Westpac*<sup>221</sup>. Secondly the case did not add anything new to the interpretation or application of the anti-avoidance provisions. It was just applying the reasoning contained in *Ben Nevis*<sup>222</sup>.

The third, and most important reason for *Westpac*<sup>223</sup> not being the settled approach to tax avoidance is that it has not provided absolute and final resolution to critical issues in the analysis process. This includes such issues as determining what crosses the line under the purpose or effect test, Parliamentary contemplation, and the extent of the reconstruction.

Take for example the reconstruction step. While Harrison J in *Westpac*<sup>224</sup> determined that the Commissioner was only entitled to reconstruct the arrangement so as ‘to counteract any tax advantage obtained’, he also acknowledged that the basis for making that reconstruction was a hypothetical scenario that would have happened, but for the arrangement. This left a dichotomy because Harrison J did not address the contradiction in those two statements. Was one required to identify the elements that gave rise to the tax avoidance or could all income or expenditure under the arrangement be reconstructed? Ultimately Harrison J<sup>225</sup> was not required to address this issue as *Westpac* failed to show that the Commissioner was in error and by how much.

But these cases, in the writer’s opinion, were obvious cases of tax avoidance as they only had one real purpose or effect, with that purpose or effect being tax avoidance. Had these cases been borderline would the judiciary have made a finding of tax avoidance in all four cases? The writer thinks not.

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<sup>220</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>221</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2.

<sup>222</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>223</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2.

<sup>224</sup> *Ibid*, at 23,940.

<sup>225</sup> *Ibid*, at 23,949.

## VIII. Problems and Solutions

Despite the writer determining, from an analysis of four recent tax avoidance cases, that the principals borne out of the *Elmiger*<sup>226</sup> case have been correctly applied as required by Parliament one still has to question whether the anti-avoidance provisions contained in the ITA 2007 are as effective as they could be.

The introduction of the choice doctrine with the release of the *O'Neil*<sup>227</sup> judgment showed that the adopting the *Elmiger*<sup>228</sup> decision as the sole basis for determining the existence of a tax avoidance arrangement was not without its flaws. Can the same be said of the current statutory framework and legislation? Given the outcomes of the recent line of tax avoidance cases, except for one, being found in favour of the Commissioner one may well think that the pinnacle of tax avoidance analysis has been reached. In the writer's opinion this is not the case.

In the next part of this paper the writer will address weaknesses in various aspects of the current statutory framework for the analysis of tax avoidance arrangements. Attempts will be made to provide solutions to these issues in the hope that their adoption will create a more cohesive framework from which to start the analysis.

The analysis will be broken down into three components. The first aspect of this analysis will look to the objectives of a tax system to determine whether the anti-avoidance provisions are meeting these basic requirements, with the second part looking to the words of the anti-avoidance provisions to determine if there are any weaknesses. Finally the analysis will cover the supporting provisions contained in the TAA 1994 and will look to see whether the shortfall penalty and promoter penalty provisions are aiding towards the achievement of the goals of the anti-avoidance provisions.

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<sup>226</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>227</sup> *O'Neil & Ors v Commissioner of Inland Revenue*, above n 11.

<sup>228</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

## **a. Objectives of a Tax System**

There are three main objectives when it comes to designing a tax system<sup>229</sup>. The first is the effectiveness objective. This objective looks to see whether Parliament's intentions are being achieved with a minimum of cost. The second objective is that of efficiency. Under this objective the tax system is designed to minimise the cost of collecting that tax and to maximise the returns from the tax systems given the constraints under which the tax system and its administration operate. This is achieved by looking at how allocative costs, which are the distortionary effects that tax can have on the economy and reflect the actual imposition of tax, and transactions costs, which reflect the costs of both administering and complying with the tax system are managed. The third and final objective is that of equity. Equity principles require that those people in similar situations be taxed in a similar manner.

These three objectives need to be balanced to ensure that in the long-run the most amount of revenue is gathered for the least amount of cost.

Clearly anti-avoidance provisions are designed, at their simplest level, to ensure that transactions and arrangements are driven predominantly by commercial considerations rather than the tax benefits. Due to the structural inequalities that exist within any tax legislation one can never design a taxation system that will completely discourage taxpayers from entering into tax avoidance arrangements. Parliament will always intend for certain tax benefits to flow from the legislation, and there will always be people willing to find any means by which they can take advantage of that benefit.

Tax avoidance behaviour confers a cost upon society as it reduces the amount of revenue received by Government. Further it adds to nothing to the economy as a whole as it takes resources away from productive areas of the economy when one has to implement and defend that behaviour. It can even conflict with the equity principle as it can push the tax burden further onto salary and wage earners as marginal tax rates are increased to ensure that sufficient revenue is gathered.

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<sup>229</sup> Robert McLeod "An Economic Approach to Taxation Avoidance" (1996) NZJTL 2(4) 171 at 172 - 173.

While the current anti-avoidance provisions work towards the achievement an effective tax system there are flaws in its current wording and application. For example the current provisions do not provide guidance as to what arrangements cross the line and become tax avoidance arrangements or how such arrangements are to be reconstructed. Further the writer has concerns as to whether the penalties placed upon those taxpayers that enter into such arrangements is an effective deterrent to such behaviours the first place. These, and other issues, will be addressed later in this paper.

If the tax system promotes equity then this can lead to greater levels of voluntary compliance as taxpayers will see that the taxation system is attempting to treat all people in similar situations the same as there will a level of perceived fairness in the tax obligations of every person. This will have an impact on the efficiency objective as it will drive down the cost of administering the tax system while at the same time maximising the amount of revenue that is to be collected.

The prevalence of tax avoidance arrangements undermines the equity objective by allowing people to avoid paying, what many would consider, their fair share of tax. In most case one would find that the taxpayers that are entering into these schemes in the first instance are usually the one that can most afford to pay the required amount of tax. Those on lower incomes are not usually in a position whereby they can manipulate their tax obligations as they are usually salary and wage earners or reliant upon a Government benefit to cover their basic living costs. When they are in a position to do so, by being self-employed for example, usually the cost of implementing such an arrangement outweighs any of the perceived benefits.

Although the anti-avoidance provisions attempt to counter such inequities, the Government does not have the resources to be able to address every tax avoidance scheme that taxpayers may enter, nor are they able to win every case that goes to court. As a result the Government needs to be very careful how it deals the settlement of any tax avoidance litigation. The structured finance litigation involving the four major trading banks is an example of this. For their part in the arrangement the four banks were able to negotiate an 80% settlement of the resulting tax liability. From a commercial stand point such a decision does make some sense as it reduces the ongoing costs for both the taxpayer and the government. From the banks perspective it was unlikely that they would win if the matter was taken further, and from the Governments

perspective there was no guarantee of a win at appeal, no matter how well the lower court judgments were decided in their favour.

Settlements do have the ability to increase the efficiency objective, but at the same they can have a detrimental effect against the equity objective. This is because they can undermine the perceived fairness of the tax system by allowing those that can most probably afford to pay the tax liability another chance to minimise their tax liability, when the average person has no ability to minimise their tax liability beyond taking advantage of the tax legislation in a manner intended by Parliament.

This can send out the wrong message to taxpayers as it can actually encourage people to enter into tax avoidance arrangements as they feel that they will have nothing to lose, and if caught can minimise the amount payable by negotiating a settlement. The result of this can be that all the objectives of a taxation system are undermined. Effectively it will create a system where it is seen that there is one rule for the rich and another rule for the poor.

In the writer's opinion the above analysis shows that there is a need for anti-avoidance provisions within the income tax legislation. Without such a provision Parliament would be continually plugging loopholes to which advantage is being taken undermining its ability to ensure that Government's objectives for the tax system are being upheld.

## **b. Specific Provisions v Anti-avoidance Provisions**

Nowhere in the history of the anti-avoidance has Parliament specifically stated the relationship between the specific provisions of the Income Tax Acts and the anti-avoidance provisions contained in those acts. It has always been left for the judiciary to make this decision. Over time this has led to contradictory views being expressed as to how the two sets of provisions are to be applied. Take for example the case of *Auckland Harbour Board*<sup>230</sup> case where the Privy Council referred to the anti-avoidance

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<sup>230</sup> *Commissioner of Inland Revenue v Auckland Harbour Board*, above n 172.

provisions as a long-stop for the Commissioner. Compare this to the cases of *Challenge Corporation*<sup>231</sup> or *Ben Nevis*<sup>232</sup>, that were decided either side of the *Auckland Harbour Board*<sup>233</sup> case, where it has been concluded that the two sets of provisions are designed to work together.

While many will see the judgment of *Ben Nevis*<sup>234</sup> as being the final word on the matter, the contradictory nature of the cases, in the writer's opinion, requires that the legislation be amended to reflect the fact that the two sets of provisions are designed to work in tandem. If this amendment is not made then there is a possibility that a future Supreme Court case could revert the position back to that of the *Auckland Harbour Board*<sup>235</sup>, resulting in the weakening of the anti-avoidance provisions.

### **c. Definition of Arrangement**

The problem with the definition of the term 'arrangement' is that within that definition the terms 'contract' and 'agreement' have been used as synonyms. The decision of *Newton*<sup>236</sup> is an example of this where it was stated that:

“Their Lordships are of the opinion that the word ‘arrangement’ is apt to describe something less than a binding contract or agreement, ...”

This interpretation does not give effect to the individual meaning given to each of the words as the term 'contract' refers to an agreement enforceable at law, while the term 'agreement' is much broader as it does not have to be enforceable at law to be effective. If the terms were defined *eiusdem generis* then the anti-avoidance provision could only be applied to situations involving formal contracts or transactions completed by deed.

Overcoming this problem, in the writer's opinion would be relatively simple as it would only require definitions of the terms to be included in section YA1 of the ITA 2007.

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<sup>231</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited*, above n 10.

<sup>232</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>233</sup> *Commissioner of Inland Revenue v Auckland Harbour Board*, above n 172.

<sup>234</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>235</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited*, above n 10.

<sup>236</sup> Above at 4, at 465.

#### **d. Scope of the Arrangement**

When trying to determine what arrangements were caught by the Australian anti-avoidance provisions Lord Denning in *Newton*<sup>237</sup> stated that:

It effects every 'contract, agreement or arrangement' ... which has the purpose or effect of avoiding tax. In applying the section you must, by the very words of it, look at the arrangement itself and see which is its effect – what it does – irrespective of the motives of the person who made it.+

Although this approach has been adopted in New Zealand it does not provide any guidance as to how the scope of an arrangement should be decided. It purely requires one to determine the effect by looking to the arrangement and the documents within. Is the approach adopted in *Peterson*<sup>238</sup> correct?

*Peterson*<sup>239</sup> has created a situation where by the Commissioner no longer has to show there has been a meeting of minds before the anti-avoidance provisions can be applied. It is now enough just to show that the person obtained a tax advantage from the tax avoidance arrangement in question. In the writer's opinion to have adopted this approach does seem a little bit unfair as the transaction entered into by the taxpayer may be part of a bigger arrangement to which they had no knowledge and could not obtain any information about even if they wanted to.

To solve this problem the writer suggest that the legislation be changed so that at a minimum the Commissioner would be required to show that a person had knowledge that the tax benefit being derived were part of a tax avoidance arrangement, even if they did not know the specific details of the arrangement.

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<sup>237</sup> Ibid.

<sup>238</sup> *Peterson v Commissioner of Inland Revenue*, above n 64.

<sup>239</sup> Ibid, at 444.



### e. Purpose or Effect Test

One of the key weaknesses with the current anti-avoidance provisions is that it does not provide any guidance as to what arrangements constitute tax avoidance arrangements, other than by stating that it must have tax avoidance as one of its purposes or effects and that the tax avoidance purpose or effect must be more than merely incidental. All of this sounds nice in theory, but how does one go about making the necessary distinction.

In *BNZ Investments Limited*<sup>240</sup> it was stated that:

Line drawing and the setting of limits recognise the reality that commerce is legitimately carried out through a range of entities and in a variety of ways; that tax is an important and proper factor in business decision making and family property planning; that something more than the existence of a tax benefit in one hypothetical situation compared with another is required to justify attributing a greater tax liability; that what should reasonably be struck at are artifices and other arrangements which have tax induced features outside the range of acceptable practice ...

From this quote one notices from the phrase “which have tax induced features outside the range of acceptable practice” that there is a requirement for one to look at subjective factors when determining whether a tax avoidance arrangement exists. The problem here is that what may be acceptable to one person may not be acceptable to another. Despite these issues *Ben Nevis*<sup>241</sup> endorsed such an approach and even introduced a set of subjective tests in order to determine the purpose or effect of an arrangement entered into by a taxpayer. These tests, while appearing to be comprehensive in their approach, require a highly level of subjectivity to be applied. The problem with this is that it requires one to place their own values onto a given set of facts. As soon as one is required to place their own values upon a given situation it can lead to a departure from Parliament’s intention.

While the tests do provide some form of guidance as how one is to determine the purpose or effect of an arrangement it can lead to a blinkered approach being taken where these test alone are considered in the decision making process, without any other

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<sup>240</sup> *Commissioner of Inland Revenue v BNZ Investments Limited*, above n 62, 463.

<sup>241</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3, at 23,212.

relevant factors being considered. This is where the risk of introducing such tests into the legislation lies. By the same token though, it will provide a greater level of certainty, by giving taxpayers a list of factors that the Commissioner will consider. This will hopefully enable taxpayers to stay within the boundaries of what is considered acceptable tax planning. Even with such tests there will always be borderline cases no matter how the anti-avoidance provisions are written. In addition such tests will help address whether the tax effect of the arrangement is more than merely incidental.

From the Commissioner's perspective these tests will need to be carefully worded so not to restrict the factors that can be considered when determining the purpose or effect of an arrangement, and ultimately the scope of the arrangement itself. To overcome this problem it would require that a catchall provision be added to the tests allowing for any other factors that the Commissioner considers relevant in the given circumstances to be considered. The unfortunate side effect of introducing a catchall provision is that it increases the level of uncertainty for taxpayers, but for the majority of cases the listed tests should be sufficient. This side effect is an inevitable by-product of trying to balance the needs of the taxpayer and the Commissioner.

Some people would argue against the introduction of such tests within the anti-avoidance provisions. The increased level of uncertainty would further blur the line as to what constitutes tax avoidance and what does not. A hopeful consequence of this would be that taxpayers would be more cautious in planning their tax affairs.

In conjunction with the introduction of these tests it would be necessary for the Commissioner to issue an interpretation statement outlining how each of the tests would be applied in a practical sense. In doing so it would provide further reassurance to taxpayers that a consistent approach is being applied to what is a rather controversial and subjective matter.

## f. Parliamentary Contemplation

Judgments such as *Challenge Corporation*<sup>242</sup> and *Peterson*<sup>243</sup> show that it is not always easy for Parliamentary intention to be determined. While New Zealand Parliamentary Debates can be used as a guide to ascertain the meaning of section it does not always provide the complete picture. Nor do Interpretation Statements or Standard Practice Statements released by the Commissioner solve the problem as these are only the Commissioner's best view as to the application of a particular piece of legislation. So how does one overcome this problem? What happens when the legislation in question lacks a clear policy?

Richardson J acknowledged this problem, and that the scheme and purpose approach is not always appropriate in the case *Commissioner of Inland Revenue v Challenge Corporation Limited*<sup>244</sup> when he stated that:

Certainly the scheme and purpose approach to statutory analysis will not furnish an automatic easy answer to these interpretation problems. Tax legislation reflects historical compromises and it bears the hands of many draftsmen in the numerous amendments made over the years. It is obviously fallacious to assume that revenue legislation has a totally coherent scheme, that it follows a completely consistent pattern, and that all its objectives are readily discernible. There is force in the thesis that in many respects the tax base is so inconsistent and contains so many structural inequities that a single general anti-avoidance provision such as sec 99 cannot be expected to provide an effective measure by which to weigh the exercise of tax preferences. ... Nevertheless, that emphasis on trying to discern the scheme and purpose of the legislation is likely to provide the legal answer to the relation between sec 99 and other provisions of the Act that best reflects the intention of Parliament as expressed in the Statute.

It has been put forward by David Dunbar<sup>245</sup> that in the Canadian context this issue is less like to arise as their legislation contains an abuse or misuse test that allows the judiciary to consider whether an incentive provision has been correctly applied. In the writer's opinion such a section does not solve the problem as it does not address the core issue as to what Parliament's intention was in the first place.

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<sup>242</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited*, above n 10.

<sup>243</sup> *Peterson v Commissioner of Inland Revenue*, above n 64.

<sup>244</sup> *Commissioner of Inland Revenue v Challenge Corporation Limited*, above n 10, at 5,020.

<sup>245</sup> David Dunbar "Judicial Techniques for Controlling the New Zealand General Anti-Avoidance Rule: The Scheme and Purpose Approach, from Challenge Corporation to Peterson (2006) 12(4) NZJTL 163 at 163.

The solution to this problem, in the writer's opinion, lies with the release of a Parliamentary commentary along with the legislation, much like the New Zealand Institute of Chartered Accountants does with their International Financial Reporting Standards. This would enable Parliament's intention for each section or part of the Act to be clearly stipulated, removing any of the ambiguity that currently. It would also prevent the judiciary from putting their own gloss onto a particular section.

Such a commentary would need to be carefully drafted in order to prevent the application of any part of the Act from being read down due to Parliament being unable to foresee all the potential ways in which a section may be applied. By the same token the commentary should not be worded so broadly that the uncertainties as to intention are reintroduced.

#### **g. Reconstruction**

The Commissioner's general power to reconstruct a tax avoidance arrangement in order to counter the tax effect of that arrangement is contained in section GA1 of the ITA 2007. This section provides very limited guidance as to how a tax avoidance arrangement should be reconstructed and requires the Commissioner to consider the hypothetical situation that would have happened had the arrangement not been entered into. The facts in cases like *Krukziener*<sup>246</sup> make it very easy for the Commissioner to identify the hypothetical scenario that would have existed outside the tax avoidance arrangement entered into. In that case it was clear that if it had not been for the arrangement entered into that the sums received by Mr Krukziener would have been assessable in his hands. Based on this how is one supposed to identify the hypothetical scenario especially in cases where there are multiple outcomes that would have been possible, or when it is completely unknown as to what the taxpayer would have done if they had not entered into the tax avoidance arrangement.

In addition the section does not specify as to whether it is all deductions or income reductions obtained under the arrangement that should be reconstructed or whether only

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<sup>246</sup> *Krukziener v Commissioner of Inland Revenue*, above n 191.

those elements of the arrangement that bring it into the realm of tax avoidance should be reconstructed. In the *Westpac*<sup>247</sup> case this matter was raised by Westpac when arguing that the external funding and the guarantee procurement fee had to be considered separately on the basis that in *Ben Nevis*<sup>248</sup> the reconstruction was limited to the licence and insurance premiums claimed. As stated earlier in this paper Harrison J could not accept this analysis based on the wording of the legislation. There was no requirement that the elements giving rise to the tax avoidance be identified separately when the Commissioner was reconstructing the arrangement.

The inconsistencies in the reconstruction of cases and the difficulties in determining the hypothetical scenario, in the writer's opinion, requires that the legislation be rewritten to specify that all deductions or reductions of income obtained under the tax avoidance arrangement be removed, as this is seen as the best means for ensuring that all tax benefits obtained from the arrangement are removed from the taxpayer.

## **h. Abusive Tax Position**

Normally once a dispute regarding a tax avoidance arrangement has been concluded in favour of the Commissioner a short fall penalty for taking an abusive tax position will be imposed in accordance with section 141D of the TAA 1994 at 100% of the resulting tax shortfall. For the section to be applied it is necessary that it can be proven that the taxpayer took an unacceptable tax position with a dominant purpose of taking, or of supporting the taking of, tax positions that reduce or remove tax liabilities or give tax benefits. The definition of an 'unacceptable tax position' is contained in section 141B of the TAA 1994 and when viewed objectively refers to a tax position that fails to meet the standard of being about as likely as not to be correct. Once the finding for the existence of a tax avoidance arrangement is made this conclusion will usually follow.

It is the second limb of the shortfall penalty that is the one that has the potential to cause problems for the Commissioner as it requires that the Tax avoidance purpose or effect

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<sup>247</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2.

<sup>248</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3 at 23,213.

be the dominant purpose or effect of the arrangement. The term ‘dominant purpose’ was defined by the Australian judiciary in the case of *Federal Commissioner of Taxation v Spotless Cleaning Services Limited*<sup>249</sup> as being the ‘most influential and prevailing or ruling purpose’. As an aid in coming to this decision a list of factors was published in Standard Practice Statement INV-215<sup>250</sup>. These factors include:

- Artificiality and contrivance
- Circularity of funding
- Concealment of information
- Spurious interpretations.

These factors are very similar in nature to those referred to in *Ben Nevis*<sup>251</sup> when determining the purpose or effect of an arrangement.

This is out of alignment with the anti-avoidance provisions themselves as they only requires that it be proven that the tax effect of the arrangement is more than merely incidental. But while the section is predominantly aimed at tax avoidance arrangements, from its very wording it can be seen to apply to all situations where a taxpayer attempts to reduce their tax liability. In order to limit its application given its wide ranging nature it has been necessary for ‘dominant purpose’ limitation to be placed upon it.

By the same token this limitation is actually beneficial to those that enter to tax avoidance arrangements due to the potential exemption created when an arrangement has multiple purposes. This can be problematic for the Commissioner when no one purpose is any more dominant than any other as it creates a situation where there is no disincentive to having entered into a tax avoidance arrangement in the first place other than having to pay the core tax and any use of money interest. Even the imposition of interest may not be enough of a disincentive as over the time of the arrangement the taxpayer may have been able to obtain a net return greater than that of the interest imposed.

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<sup>249</sup> *Federal Commissioner of Taxation v Spotless Cleaning Services Limited* 96 ATC 5201 (HCA).

<sup>250</sup> Inland Revenue *Standard practice statement INV-290: promoter penalties* (2004).

<sup>251</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3, at 23,212.

To ensure that the penalty will apply to all tax avoidance arrangements the writer contends that it is necessary for a subsection to be inserted that makes specific reference to tax avoidance arrangements and aligns the threshold requirements with the anti-avoidance provisions to require that the tax purpose or effect is 'more than merely incidental'. To do otherwise would allow all but the most blatant of case to avoid having a penalty imposed.

Even if a shortfall penalty for taking a an abusive tax position could be imposed in every case of tax avoidance would this be enough to create a further disincentive to enter into a tax avoidance arrangement? The recent cases would suggest not. In the first instance the taxpayer would normally be entitled to a shortfall penalty reduction of 50% in accordance with section 141FB of the TAA 1994 if the tax position is taken after 26 March 2003. This is because it is most likely that the taxpayer will not have had this particular shortfall penalty imposed upon them within four years from the date upon which the tax position relating to the penalty was taken and the date that the tax position for the current case was taken. The main reason for this can be seen from the long line of tax avoidance cases in which special purpose entities are usually established in order to execute the arrangement, even though the same natural persons are behind the new entities.

Where is the true disincentive if a natural person can execute multiple tax avoidance arrangements and be entitled to a reduction in the penalty imposed in every case? To counter this problem the writer suggest that since tax avoidance is a deliberate act that the 50% reduction given by section 141FB of the TAA 1994 be removed in such instances.

A final question is raised as to whether the imposition of the penalty at 100% provides enough of a disincentive in itself. The writer's opinion is that it has not been enough of a disincentive to taxpayers. One just has to look at the long line of tax avoidance case to realise this. Therefore the writer recommends that the penalty be raised to 200%. While this may seem like an arbitrary figure it is believed that this creates a significant disincentive while at the same time appearing to be both fair and reasonable.

Would such a high penalty have prevented cases like *Ben Nevis*<sup>252</sup> or *Westpac*<sup>253</sup>? Regardless of how high the penalty is there will always be people willing to enter into tax avoidance arrangements as they feel that the gains outweighs any of the negatives, that the scheme could never be found to be one of tax avoidance in the first case, or they will never be audited by the Inland Revenue.

### **i. Promoter Penalties**

On 26 March 2003 section 141EB of the Tax Administration Act 1994 was enacted, with effect from 26 March 2003. The purpose of this section was to create a further deterrent to the implementation of tax avoidance arrangements by introducing a promoter penalty. Previously the creators and marketers of such schemes could not be penalised for their actions. To date the Commissioner has not applied this section.

The penalty is designed to apply to a person who ‘promotes’ a tax avoidance arrangement to at least 10 or more people, in a tax year, with at least one of those persons claiming a tax related advantage from that arrangement to which the Commissioner has applied a shortfall penalty for taking an abusive tax position.

The first element of this section is the term ‘promoter’ which is defined in section 141EC of the TAA 1994. The definition refers to:

- A person who is a party to, or is significantly involved in formulating, a plan or programme from which an arrangement is offered; or
- A person who is aware of material and relevant aspects of the arrangement and who sells, issues or promotes the selling or issuing of, the arrangement, whether or not for remuneration.
- But does not include a person whose involvement with the arrangement is limited to providing legal, accounting, clerical or secretarial services to a promoter.

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<sup>252</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>253</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2.



The legislation itself does not provide any guidance as to how to determine whether any of the above criteria are met, but the Commissioner has provided some guidance in the form of a standard practice statement<sup>254</sup>. The statement suggests that the following criteria be considered when determining whether a person is significantly involved in the arrangement:

- The flow money and profits
- The level of input the person has into the design of the arrangement
- The level of knowledge the person has with respect to the operation and effects of the arrangement
- The creation of the documents relevant to the arrangement.
- The involvement in the advertising and promotional material.

Based on the legislative definition and the above criteria a person who offers the arrangement, but is not involved in its creation can be deemed to also be a promoter if they have sufficient knowledge as to its operation. Usually it will be relatively straight forward to determine the person or persons involved in the formulation and creation of the arrangement, but this may not be the case when it comes to those that are purely marketing the scheme as this may require a high degree of circumstantial evidence . To avoid this issue and to discourage people from just selling the arrangement without the respective knowledge the writer recommends be amended so that it could apply to all people involved in the marketing of the arrangement.

The second limb of the section requires the arrangement to be offered, sold, issued or promoted to 10 or more persons, with at least one person claiming a tax related benefit. The problem with this requirement is that the arrangement being offered to each person must be identical. In circumstances where it is necessary to modify the arrangement for each person, or the promoter is involved in the creation of multiple boutique tax avoidance arrangements the penalty cannot apply. As case law shows that the majority of arrangements are boutique in nature, it means that the bulk of people involved in the formulation of tax avoidance arrangements will never be penalised for their actions. Where is the disincentive in that?

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<sup>254</sup> Inland Revenue *Standard practice statement INV-290: promoter penalties*, above n 253.

To overcome this overcome this problem the writer suggests that the section be given a much broader application by having apply to all tax avoidance arrangements that result in a tax related benefit being claimed, regardless of the number of people to which the arrangement is marketed. This would bring the promoter penalty in line with the evasion penalty and the aiding or abetting penalty, contained in sections 143B and 148 of the TAA 1994 respective, as those sections penalise a person who helps another person to defraud the tax system.

## IX. Conclusion

Since the introduction of anti-avoidance provisions in 1878 it can be seen that they have come a long way in terms of their construction, interpretation and application, and have become a well-grounded and fleshed out framework by which potential tax avoidance arrangements can be analysed. But have we arrived at position where one can categorically state, with hand on heart, that this framework is as strong as it could be and does not require any further work on the part of either the judiciary or Parliament? In the writer's opinion we have unfortunately not reached such a position, despite the strong gains that have been made in this area over the years. As part of this it is good to see that the judiciary have made the anti-avoidance provisions a cornerstone of the income tax legislation, rather than just a long stop for the Commissioner as promulgated in *Auckland Harbour Board*.

Cases such as *Elmiger*<sup>255</sup>, *O'Neil*<sup>256</sup> and *Ben Nevis*<sup>257</sup> have provided the judiciary with unique opportunities to further refine and hone the anti-avoidance provisions into a more precise tool for countering tax avoidance arrangements. *Elmiger*<sup>258</sup>, being the first tax avoidance case decided in favour of the Commissioner, enabled the judiciary to establish a framework by which all arrangements are to be judged. Despite the age of this case the framework has remained relatively robust with only a few amendments along the way. *O'Neil*<sup>259</sup> was one of those amendments as it introduced the concept of the 'choice doctrine', enabling the judiciary to look at Parliament's intention in relation to the application of a specific provision of the ITA. *Ben Nevis*<sup>260</sup> was able to introduce a twofold inquiry with a set of eight tests that were designed to look at the subjective matters that underscored the reality of the arrangement entered into in light of the statutory provision that the taxpayer was attempting to take advantage of.

*Westpac*<sup>261</sup> after having had the advantage of the decision of *Ben Nevis*<sup>262</sup> failed to capitalise upon that ruling in a bid to further strengthen the application of the anti-

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<sup>255</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>256</sup> *O'Neil & Ors v Commissioner of Inland Revenue*, above n 11.

<sup>257</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>258</sup> *Elmiger and Another v Commissioner of Inland Revenue*, above n 1.

<sup>259</sup> *O'Neil & Ors v Commissioner of Inland Revenue*, above n 11.

<sup>260</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

<sup>261</sup> *Westpac Banking Corporation v The Commissioner of Inland Revenue*, above n 2.

<sup>262</sup> *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 3.

provisions. As an example *Westpac* had the opportunity to discuss the extent and scope of the subjective tests, but failed to do so. Due to New Zealand's size we cannot afford to allow such opportunities like this to pass us by as there are only going to be a limited number of cases in which such in-depth analysis can be undertaken. As a result *Westpac*<sup>263</sup> was unsuccessful in its bid to settle the approach to tax avoidance in New Zealand.

In spite of the refinements to the legislation and judicial thinking on the subject the current statutory framework is not without its flaws and weaknesses. Every step within the framework appears to have its problems. From the problems identified the writer has devised potential solutions. Would all of these solutions lead to the Commissioner being able to reconstruct all tax avoidance arrangements that came to his attention? Only by their real world application could one test the strength of the solutions proposed.

At the end of the day the reality is that there will always be tax avoidance arrangements due to Parliament deliberately building structural inequalities into the legislation. This can never be overcome due to the competing needs of the society in which we live. All that can be demanded of Parliament and the judiciary is that take every opportunity to strengthen the application of the anti-avoidance provisions in a bid to provide a tax system that helps move the economy forward.

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<sup>263</sup> *Westpac banking Corporation v The Commissioner of Inland Revenue*, above n 2.

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