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31 March 2021

Tax Counsel Office
Inland Revenue Department
New Zealand

By email: Public.Consultation@ird.govt.nz
Your Reference: PUB00305

Dear Sir or Madam,

Draft statement on tax avoidance

CPA Australia represents the diverse interests of more than 168,000 members, including over 2,600 members in New Zealand, working in over a 100 countries and regions supported by 19 offices around the world. We make this submission on behalf of our members and in the broader public interest.

The Inland Revenue's (**IRD**) draft interpretation statement and Questions asked (**QWBA**) on:

1. **PUB00305: Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA1 of the Income Tax Act 2007** (**Draft Statement**):
2. **Question PUB00305 QB1: Income Tax: scenarios on tax avoidance – reissue of QB 14/11 scenario 1 and QB 15/11 scenario 2 (Draft QWBA QB1)**; and
3. **Question PUB00305 QB2: Income tax: scenarios on tax avoidance – reissue of QB 15/11 - scenario 1 and 3 (Draft QWBA QB2)**

seeks submissions on the proposed change to the current interpretation statement **IS 13/01** **(Current Statement)**.

All legislative references are referable to the *Income Tax Act 2007* (ITA 2007) unless otherwise indicated.

The proposed changes in the Draft Statement are welcomed. Our main comments are:

- We agree with the Commissioner to emphasise that the focus when applying section BG 1 is on answering the "ultimate question" posed by the Supreme Court in *Ben Nevis*[1] when it set out the Parliamentary contemplation test. However, we believe this should not be at the expense of a reduced emphasis in identifying whether there is a mismatch of facts, features and attributes between what Parliament would have contemplated and those that appear in the arrangement in economic substance.
- We agree with the Commissioner's position that the merely incidental test involves consideration of many of the same factors that are considered under the Parliamentary contemplation test. However, we question whether it may be necessary to amend section YA 1 to more closely align it with the adoption of a greater focus by the Commissioner on an arrangement's commercial and private purposes (i.e. non-tax avoidance purposes) at the stage of answering the Parliamentary contemplation test.
- We also question whether the adoption of a "greater focus" is warranted, given the judiciary firmly endorses the economic substance approach and it is already considered in the second step when applying the merely incidental test as provided for in section YA 1.

Our comments on the proposed changes are outlined in the Attachment.

[1] ***Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008]** NZSC 115, [2009] 2 NZLR 289

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Yours sincerely,

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Executive General Manager,
Policy and Advocacy

Mr Rick Jones
Country Head,
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For Public comment: Proposed Changes

The Draft Statement emphasises that the focus when applying section BG 1 is on answering the "ultimate question" posed by the Supreme Court in Ben Nevis when it set out the Parliamentary contemplation test.

*The ultimate question is **whether the arrangement, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament's purpose**.*

Proposed change

The Current Statement gives significant emphasis to identifying whether there is a mismatch of facts, features and attributes between what Parliament would have contemplated and those that appear in the arrangement in economic substance. Facts, features and attributes are those things Parliament would contemplate being present (or absent) when permissible tax advantages arise under the specific provision.

The Draft Statement still accepts that considering whether any facts, features or attributes are present (or absent) in the arrangement can be useful. However, it makes it clearer that the emphasis and focus must be on answering the ultimate question. That is, whether the arrangement as a whole, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament's purpose. The Commissioner is particularly interested in receiving submissions on this change to the statement and the continued role of facts, features and attributes.

The parliamentary contemplation test adopted in *Ben Nevis* enables the courts to grapple directly with what most would see as objectionable about tax avoidance. In *Ben Nevis*, Tipping, McGrath, and Gault JJ said:

> When, as here, a case involves reliance by the taxpayer on specific provisions, the first enquiry 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 the 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 purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement ... 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. It is not within Parliament's purpose for the specific provisions to be used in that manner.[2]

The test provides a reasonably straight forward approach to the determination of tax avoidance, i.e. the courts apply the test to transactions designed to obtain a tax benefit in an artificial or contrived way with no business purpose, and do so on the grounds that the use of primary provisions to gain such a benefit is not within Parliament's purpose.

The judicial approach in *Ben Nevis* is to consider whether the particular arrangement in question was structured and carried out in a commercially and economically realistic way to determine whether the use of the tax provision by the taxpayer would be consistent with Parliament's purpose. The Commissioner recognises that in Draft QWBA QB1 and Draft QWBA 2, answering this question requires viewing the arrangement as a whole in a commercially and economically realistic way, using the factors the courts have found relevant. These include:

- whether the taxpayer has gained the benefit of the specific provision in an artificial or contrived way, or by pretence;
- the manner in which the arrangement is carried out;
- the role of all relevant parties and their relationships;
- the economic and commercial effect of documents and transactions;
- the nature and extent of the financial consequences;
- the duration of the arrangement;
- whether there is circularity in the arrangement;
- whether there is inflated expenditure or reduced levels of income in the arrangement;
- whether the parties to the arrangement have undertaken limited or no real risks; and
- whether the arrangement is pre-tax negative.[3]

Based on the above, we agree with the Commissioner's approach to emphasise that the focus when applying section BG 1 is on answering the "ultimate question" posed by the Supreme Court in *Ben Nevis* when it set out the Parliamentary contemplation

[2] Ibid 331-332 [107-108]

[3] **Information Sheet: Draft statement on tax avoidance released for public comment**, 17 December 2020

test, i.e. 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.

However, we submit that it is important to ensure this is not done at the expense of a reduced emphasis on what the current statement provides, i.e. the significant emphasis in identifying whether there is a mismatch of facts, features and attributes between what Parliament would have contemplated and those that appear in the arrangement in economic substance.

The reason to view the arrangement as a whole as pointed out by the Commissioner, is that it is important to remember that in *Ben Nevis*, the Supreme Court of New Zealand has clarified for the arrangement under examination, the application of section BG 1 is done by applying a two-step tandem process. This requires:

- the first step, which is to determine whether the provision has been used within its intended scope and then,
- the second step, which is to consider the taxpayer's use of the specific provision in light of the arrangement as a whole.[4]

In considering the arrangement as a whole, we submit it is necessary to first identify the facts, features and attributes of the arrangement and whether these facts, features and attributes were then designed to obtain a tax benefit in an "artificial" or "contrived" way. The Commissioner was correct in the Current Statement to recognise the importance of the facts, features and attributes as being those things Parliament would contemplate being present (or absent) when permissible tax advantages arise under the specific provision.

We further submit that the increased emphasis and focus when applying section BG 1 is on answering the "ultimate question" posed by the Supreme Court in *Ben Nevis* when it set out the Parliamentary contemplation test. It should be viewed as a subsequent analysis and deduction, after identifying the facts, features and attributes of the arrangement. That is, in answering the "ultimate question", i.e. whether the arrangement as a whole, viewed in a commercially and economically realistic way, uses or circumvents the specific provisions in a manner that is consistent with Parliament's purpose, is a subset in the consideration of the whole arrangement and this is at a later point in time, albeit without doubt, a quintessential one. This is supported by the fact that the courts in Canada, Australia, and New Zealand all seem to apply their respective general anti-avoidance rules (GAAR) to transactions designed to obtain a tax benefit in an "artificial" or "contrived" way. They do so on the grounds that the use of the primary provisions to gain such a tax benefit is not within Parliament's purpose.[5]

Proposed change

The Draft Statement also adopts a greater focus on an arrangement's commercial and private purposes (ie, non-tax avoidance purposes) at the stage of answering the Parliamentary contemplation test. In the Current statement, the focus on non-tax avoidance purposes arose when applying the merely incidental test, where non-tax avoidance purposes are also relevant.

The ITA 2007 uses the purpose test to positively identify tax avoidance arrangements. Section YA 1 defines "tax avoidance arrangement" to mean:

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

This wording of the term 'tax avoidance arrangement' under the New Zealand GAAR means tax avoidance does not have to be the sole or dominant purpose and only has to be one of the purposes and effects, although not one that is merely incidental.[6]

As discussed, the second step in applying section BG 1 involves determining if there is a purpose or effect of tax avoidance in the arrangement, and this is legislated in section YA 1, which provides that if tax avoidance or effect is the sole purpose, or one which is not merely incidental, of the arrangement, then the GAAR can apply to void the tax benefits obtained from the arrangement. This is in accordance with the Current Statement.

As written by Tretola (2017):

> "the purpose or effect in this context requires looking at the end in view but that the two words do not have any independent meanings.[7] The test for purpose is objective and so subjective motivations are not relevant. If the arrangement in question has a tax avoidance purpose, then the next question to be considered is whether the arrangement is referable to ordinary business or family

[4] Tretola, John (2017), **"Comparing the New Zealand and Australian GAAR"**, *Revenue Law Journal*, Vol. 25 : Issue 1, Article 3, p. 4
[5] Hwong, Thaddeus and Li, Jinyan (2020), **"GAAR in Action: An Empirical Study of Transaction Types and Judicial Attributes in Australia, Canada, and New Zealand"**, *Canadian Tax Journal*, 68:2, p551
[6] Tretola, John, above n 4, p 3
[7] Ibid, referring to *Ashton v C of IR* (1975) 2 NZTC 61,030 (Privy Council) at 61,030, 61,034. p 5

> dealings. This is necessary to determine whether or not the tax avoidance purpose is more than merely incidental to the arrangement."[8]

We agree with the Commissioner's position that the merely incidental test involves consideration of many of the same factors that are considered under the Parliamentary contemplation test. A conclusion under the Parliamentary contemplation test that an arrangement has a tax avoidance purpose or effect means it is very unlikely that the arrangement's tax avoidance purpose will be merely incidental. This is borne out in Step 1, as evidenced by the facts, features and attributes of the arrangement.

However, we question whether it may be necessary to amend section YA 1 to more closely align it with the adoption of a greater focus on an arrangement's commercial and private purposes (i.e. non-tax avoidance purposes) by the Commissioner at the stage of answering the Parliamentary contemplation test, as opposed to the current focus of non-tax avoidance purposes arising when applying the merely incidental test.

We also question whether the adoption of a "greater focus" on an arrangement's commercial and private purposes at the stage of answering the Parliamentary contemplation test is warranted, given the judiciary firmly endorses the economic substance approach and it is already considered in the second step when applying the mere incidental test as provided for in section YA 1. In *Ben Nevis*:

> 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.[9]

The "purposive interpretation" doctrine also emboldens courts to look through the legal form of the arrangements for the economic substance:

> As Parliament's purpose in enacting specific provisions is axiomatically targeted at the most commonplace and conventional issues which arise, anything that indicates an unusual or contrived application of a provision is also likely to indicate that the provision was not used in the way Parliament thought it would be. If enough of these abnormalities are present, and are also accompanied by tax advantages, then it is a fair conclusion that the use is outside Parliamentary contemplation and the GAAR applies.[10]

Other comments:

- It would be good for the Commissioner to include some practical examples (in addition to those proposed from the two revised QWBAs), that show more clearly the boundary between acceptable tax planning and tax avoidance.
- The Commissioner should issue a draft replacement QWBA for QB 15/01: *Income tax – tax avoidance and debt capitalisation*, as there appears to be no basis as to why it should be withdrawn without a replacement draft.
- There is no discussion in the Draft Statement of the High Court's case in ***Philippa White v CIR***, where the court held that amalgamation of a medical practice and a business into a single corporate entity was not tax avoidance. To be balanced, the IRD should discuss this case as it provides a clear example of where an arrangement was made that was determined to not have been done so for tax avoidance reasons. Another case that was not discussed but which has potential relevance is ***Roberts v CIR*** **[2019] NZCA 654** on the use of extrinsic materials, which would provide taxpayers and their advisers with more useful guidance.
- The Draft Statement may also need to be updated in due course for the Supreme Court's decision in ***Frucor*** when this is delivered. At this time, it is not clear what impact this case may have, including with respect to the new Base Erosion and Profit Shifting (**BEPS**) provisions.
- From an administrative perspective, we note the Australian Taxation Office (**ATO**) operates a **GAAR Panel** to advise on the application of GAARs to particular arrangements. The Panel is made up of business and professional people chosen for their expertise and senior ATO staff. Establishing such a panel may further assist the IRD's approach to GAAR cases by enabling the input of external experts while retaining decision-making authority. Practice Statement **PS LA 2005/24 Application of General Anti-Avoidance Rules** provides further information on the role and operation of the GAAR Panel.

[8] Ibid, p 5
[9] Hwong, Thaddeus and Li, Jinyan (2020), n 5, p 558
[10] Ibid, p 559