

# **A COMPARATIVE STUDY OF THE AUSTRALIAN AND NEW ZEALAND JUDICIAL APPROACHES TO ANTI AVIODANCE LEGISLATION.**

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# A comparative study of the Australian and New Zealand judicial approaches to anti avoidance legislation.

## 1 INTRODUCTION.

A number of Commonwealth countries have adopted some form of a general anti avoidance rule which is designed to deal with the difficulty of an income-tax act effectively anticipating how taxpayers will respond to a statutory rule. Australia and New Zealand originally enacted similar general anti avoidance rules. In both countries subsequent judicial decisions led to amendments. The original New Zealand anti avoidance rule (section 108) was amended in 1974 and is contained in section BG 1 of the Income Tax Act 2004 (the ITA). The original Australian provision section (section 260) was replaced in 1981 by Part 1VA of the ITAA 1936. Both of these amendments were designed to solve the problem summarised by the then Treasurer (now Prime Minister John Howard) who described the objective in these terms:

*“The proposed provisions embodied in a new Part IVA seek to give effect to a policy that such measures ought to strike down blatant, artificial or contrived arrangements but not cast unnecessary inhibitions on normal commercial transactions by which taxpayers legitimately take advantage of opportunities available for the arrangement of their affairs”.*

Later in his speech the Treasurer re affirmed the limited scope of the new legislative solution when he said:

*“In order to confine the scope of the proposed provisions to schemes of the “blatant” or “paper” variety, the measures in this Bill are expressed so as to render ineffective a scheme whereby a tax benefit is obtained and an objective examination, having regard to the scheme itself and to its surrounding circumstances and practical results, leads to the conclusion that the scheme was entered into for the sole or dominant purpose of obtaining a tax benefit.”<sup>1</sup>*

The views of the Treasurer are supported by the Explanatory Memorandum (EM) which accompanied the Bill. The explanation in the EM stated that the aim of the Bill was to restore the anti avoidance rule to the position as it was understood immediately after the decision of the Privy Council in *Newton*. The same can be said of the New Zealand equivalent legislative amendment which occurred in 1974 which was also concerned with preventing blatant, artificial or contrived types of tax avoidance not ordinary commercial transactions.

The purpose of this paper is to:

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<sup>1</sup> Second reading speech, *Income-tax laws Amendment Bill (No.2) 1981*, *Hansard*, House of Representatives, 27/5/1981.

1. exam the Australian and New Zealand experience to see whether this prediction was correct,
2. consider whether the New Zealand judicial approach to the interpretation of section BG 1 of the ITA would alleviate some of the recent frustration expressed by a number of commentators over the decision of High Court in *FCT v Hart* (2004) 55 ATR 712,
3. consider how the three most recent decisions of the High Court of Australia on the application of Part 1VA ITAA 1936 would have been decided under section BG 1 of the ITA.

## **2 Reaction to the High Court of Australia decision in *FCT v Hart***

This paper was triggered by a comment by Professor Graeme Cooper who recently referred to a:

*“Sense of frustration with the emerging interpretation of Part 1VA, that is, the inability of taxpayers and their advisors to predict accurately the likely application of Part 1VA or immunity of transactions from attack- can be gauged by comparing some of the literature which emerged after the decision in *FCT v Hart*”.*<sup>2</sup>

In that article Professor Cooper refers to recent articles by:

1. C Beavan,
2. M Cashmere,
3. P Dovan,
4. R Edmonds,
5. DG Hill.

Similar concerns have been raised Justice Ronald Sackville<sup>3</sup> and Nicole Wilson-Rogers.<sup>4</sup> The only dissenting voice appears to be an article by D Carbone and J Tretola.<sup>5</sup>

In *Macquarie Finance v FCT* [2004] FCA 1170 at 120, Hill J held that Part 1VA ITAA 1936 applied to disallow the interest deduction. His honour concluded his judgement with the observation that he reached:

*“this conclusion with some reluctance. I doubt if the legislature would have regarded the scheme as involving the application of Part 1VA ITAA 1936 when the part was enacted in 1981. However, it seems to me that the approach of the High Court in *Hart* requires me to reach the conclusion I have.”*

This paper will also consider whether the concerns raised by these eminent commentators would be satisfied if the High Court of Australia were to adopt the

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<sup>2</sup> G Cooper *The Emerging High Court Jurisprudence on Part 1VA* The University of Sydney Law School Legal research Paper No. 06/09 at page 3 footnote 18. See also *The Emerging High Court Jurisprudence on Part 1VA* The Tax Specialist Vol 9 No5 June 2006 235.

<sup>3</sup> Taxation in Australia Issue 39 No 6 Dec 2004 - Jan 2005 p295.

<sup>4</sup> eJournal of Tax Research Vol 4, no1, (August 2006) p25

<sup>5</sup> (2005) 34 AT Rev 196.

current New Zealand approach to the interpretation of section BG 1 of the ITA which is colloquially known as the “scheme and purpose” approach. The significance of the New Zealand solution can be tested by evaluating the likely results which would have occurred in for example *Harts* case, *Consolidated Press*, and *Spotless Services*.

### **3 Outline of the paper and recent New Zealand cases**

#### **3.1 Outline of paper**

This paper has attempted to answer these questions by summarising in section 4 both countries experience with general anti avoidance rule. Section 5 will briefly consider the inherent problems created for the judiciary by anti avoidance legislation. The paper will then trace in section 6 the history of the New Zealand scheme and purpose approach. This will provide a platform for considering in sections 6, 7, 8, 9, and 10 how the judiciary in each country responded to the legislative challenge of interpreting the original anti avoidance rules. Sections 11 and 12 consider the application of the scheme and purpose approach by the Privy Council and Court of Appeal in a number of recent New Zealand cases. Section 13 contains a tentative analysis of how that approach could apply to the three recent decisions of the High Court of Australia. Finally section 14 considers how the New Zealand approach could be incorporated into Part 1VA ITAA 1936.

#### **3.2 Recent New Zealand anti avoidance cases**

Since 2001, the Privy Council have considered the application of section BG 1 of the ITA in the following three cases:

1. *Peterson v CIR*.<sup>6</sup>;
2. *CIR v Auckland Harbour Board*<sup>7</sup>; and
3. *O’ Neil v CIR*<sup>8</sup>.

In addition to those three cases, the Court of Appeal has considered the application of section BG 1 of the ITA in two additional cases which were not taken on appeal to the Privy Council:

1. *Dandelion Investments Ltd v CIR*<sup>9</sup>,
2. *CIR v BNZ Investments Ltd*.<sup>10</sup>

However the CIR was only successful in *O’Neil* and *Dandelion Investments Ltd*.

#### **3.3 O’ Neil v CIR<sup>11</sup>.**

The CIR was successful in this case before the Court of Appeal and the Privy Council. This case involved a sophisticated scheme which was based on a temporary sale of a profitable company to a tax loss company. The net profit before tax of the profit company was paid to the loss company as a deductible management fee. The loss company then used that cash flow to pay the purchase price for the profitable

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<sup>6</sup> (2005) 22 NZTC 19,098.

<sup>7</sup> (2001) 20 NZTC 17,008.

<sup>8</sup> (2001) 20 NZTC 17,051.

<sup>9</sup> (2003) 21 NZTC 17,293.

<sup>10</sup> (2001) 20 NZTC 17,103.

<sup>11</sup> (2001) 20 NZTC 17,051.

company. The tax advantage sought from the arrangement was the conversion of pre-tax income into a tax-free capital gain.

### **3.4 Dandelion Investments Ltd v CIR<sup>12</sup>**

The CIR was successful before the Court of Appeal. The case involved a circular self-cancelling transaction which was designed to take advantage of a statutory mismatch which enabled a taxpayer to claim an interest deduction without having to show that the borrowed money was used to generate assessable income<sup>13</sup>. There was no business or commercial objectives which could have justified the arrangement which would never have been entered into if the tax mismatch was not available.

### **3.5 CIR v BNZ Investments Ltd.<sup>14</sup>**

The CIR was unsuccessful before the Court of Appeal. The case was conceptually similar to *Dandelion Investments Ltd.* in that the scheme sought to take advantage of the same statutory mismatch. An important factual distinction was that the taxpayer was not aware of the circular nature of the cash flow. The taxpayer believed the funds were ultimately used to finance a credible commercial investment.

### **3.6 CIR v Auckland Harbour Board<sup>15</sup>;**

The CIR was unsuccessful before the Privy Council. Briefly the taxpayer formed a charitable trust to frustrate local government reform. Income which would otherwise have been derived by the taxpayer was diverted to the charitable trust. Furthermore the taxpayer was able to claim a tax deduction for the loss associated with the gift of the financial arrangements to the charity.

### **3.7 Peterson v CIR.<sup>16</sup>;**

The CIR was successful before the Court of Appeal, but failed before the Privy Council. Briefly the case involved a passive investment made by a group of professional taxpayers in a film production syndicate. Fifty seven percent of the available tax deductions were financed by a limited recourse loan which was part of a circular transaction that was never repaid.

### **3.8 The fountain head of the scheme and purpose approach: CIR v Challenge Corporation Ltd.<sup>17</sup>**

Each of these five cases to a greater or lesser extent refers to the judgment of Richardson J in *Challenge Corporation Ltd.* That case involved a simple transaction whereby the taxpayer purchased a loss company on the 31st of March. The purchase price was based on the tax saving which would arise if the taxpayer could group its pre tax income with the available tax losses of the Loss Company

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<sup>12</sup> (2003) 21 NZTC 17,293.

<sup>13</sup> Section CW10 at that time provided that all intercompany dividends passed free of tax including dividends sourced from off shore. Section DB 8 creates an interest deduction for borrowed money which is used to subscribe for share capital in a wholly owned group company without the need to show that any income was produced by the borrowing company or the group company.

<sup>14</sup> (2001) 20 NZTC 17,103.

<sup>15</sup> (2001) 20 NZTC 17,008

<sup>16</sup> (2005) 22 NZTC 19,098.

<sup>17</sup> (1986) 8 NZTC 5,001 (CA).

## **4 Legislative history**

### **4.1 Section 260 of the ITAA 1936**

For the purposes of this paper the original general anti avoidance rules in Australia and New Zealand have been treated as section 260 and section 108 respectively. These two pieces of legislation were sufficiently similar to enable a comparison to be made of each countries judicial approach which will provide a platform for evaluating the suitability of applying the New Zealand approach to resolve the current Australian frustration with Part 1VA.

Section 260 of the ITAA 1936 provided that:

*“Every contract, agreement, or arrangement made or entered into, shall so far as it has or purports to have the purpose or effect of in any way, directly or in indirectly:*

- (a) altering the incidence of any income-tax;*
- (b) relieving any person from liability to pay any income-tax;*
- (c) defeating, evading or avoiding any liability imposed on any person by this act; or*
- (d) preventing the operation of this act and any respect,*  
*be absolutely void, as against the Commissioner, in regard to any proceeding under this Act...”*

### **4.2 Section 108 of the Land and Income Tax Act 1954**

Section 108 of the Land and Income Tax Act 1954 (LITA 1954) provided that:

*“Every contract, agreement, or arrangement made or entered into, shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in anyway altering the incidence of income tax, or relieving any person from his liability to pay income-tax.”*

### **4.1 The current New Zealand general anti avoidance rule**

The New Zealand Income-Tax Act 2004 (ITA) contains a general anti-avoidance rule in section BG 1 which provides:

*“a tax avoidance arrangement is void as against the Commissioner [of Inland Revenue] for income tax purposes.”*

One of the key ingredients is the phrase “tax avoidance arrangement” which is defined in section OB 1 of the ITA as:

*“tax avoidance arrangement means any arrangement, whether entered into by the person affected by the arrangement or any other person, that directly or indirectly-*

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

The “scheme and purpose” approach to the interpretation of section BG 1 of the ITA is an interpretative approach to paragraphs (a) and (b) which enables the New Zealand courts to distinguish between legitimate and illegitimate tax planning.

The definition of tax avoidance arrangement in turn refers to “tax avoidance” which is defined in section OB 1 of the ITA as:

“*Tax avoidance includes -*

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

## **4.2 The current Australian general anti avoidance rule**

As noted above Part 1VA ITAA 1936 was designed to restore the law to the position prior to *Newton* and *Keighery*. The current anti avoidance rule has three components.

The taxpayer must:

1. obtain a tax benefit,
2. from a scheme,
3. which was entered into by the taxpayer for the sole or dominant purpose of obtaining a tax benefit.

This test focuses on the dominant purpose of the taxpayer not of the scheme. The dominant purpose is determined having regard to eight specified criteria which include inter alia:

1. the manner in which the scheme was entered into or carried out;
2. the form and substance of the scheme;
3. the time at which the scheme was entered into and the length of time during which the scheme was carried out;
4. any change in the financial position of any one connected with the scheme.

## **5 The conceptual problem of designing a general anti avoidance rule**

### **5.1 Is it possible to devise a workable definition of tax avoidance?**

What is tax avoidance? An often quoted definition is the description of Lord Nolan in *IRC v Willoughby*<sup>18</sup> who defined tax avoidance as: “*a course of action designed to conflict with or defeat the evident intention of Parliament.*”

In 1997 Lord Templeman said: “*tax avoidance reduces the incidence of tax borne by an individual taxpayer contrary to the intentions of Parliament*”.<sup>19</sup>

The Tax Law Review Committee (TLRC)<sup>20</sup> adopted a similar approach in their draft alternative clause which provided that:

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<sup>18</sup> [1997] S.T.C. 995, 1004c.

<sup>19</sup> Tax Avoidance and the Law, (Adrian Shipwright (ed), Key Haven, London, 1997) at 1.

*“the purpose of this rule is to deter or counteract transactions that are designed to avoid tax in a way that conflicts with or defeat the evident intention of Parliament”*

The TLRC report did not define the word “avoid”

These three definitions are based on the principle that the court should not assume that Parliament intended to allow taxpayers to defeat its intention through artificial or contrived transactions. It is not a rational approach to statutory interpretation to presume that a tax law provides an escape from the liability it sought to impose. An important question is how do the taxpayers ascertain the intention of Parliament? The conventional answer is that the only way is to read the statutory language used to enact the particular taxation law in dispute.<sup>21</sup> This appears to create a logical conundrum.

Many cases on tax avoidance involve arrangements which seek to take advantage of the absence of any such evident intention in the words used in the statute which is why the alleged tax avoidance arrangement was entered into in the first place. If in a particular case Parliament has considered the specific circumstances created by the taxpayer the legislation would invariably have prescribed the tax consequences. The problem is that often Parliament only enacts a general rule and does not consider or anticipate all of the possible variations in commercial transactions which are sometimes deliberately designed to take advantage of the general rule in an unintended manner. This invariably leads to the conclusion that tax avoidance cannot be determined by reference to whether Parliament’s intention has been frustrated because in the many cases there is no clear answer which can be deduced from the statutory language or from Hansard. Accordingly often the courts are being asked to

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<sup>20</sup> *Tax Avoidance* published by The Tax Law Review Committee Institute for Fiscal Studies November 1997 ISBN 1-873357-75-3 Executive Summary, paragraph 7, and appendix 2 pg 59.

<sup>21</sup> See for example Lord Hoffmann *Tax Avoidance* 2005 BTR 197, 206.

second-guess what Parliament would have enacted if it had considered the particular transaction that is now before the courts. The judiciary are often being asked to determine the unknowable

## 5.2 The Nature of General Anti Avoidance Rules.

The facts in the five recent cases suggest that the CIR is using section BG1 to try and over turn transactions that he believes are inconsistent with, or defeat the legislative intention of Parliament. Nabil Orow discusses this type of justification in a scholarly article published recently in the British tax review <sup>22</sup> and by Professor Graham Cooper in the opening chapter of *Tax Avoidance and the Rule of law* (1997)<sup>23</sup>.

It was the conceptual rationale put forward in the 1997 Report by the Tax law Review Committee “*Tax Avoidance*” which recommended the enactment of a GAAR for the United Kingdom.<sup>24</sup> The Committee described the problem in these terms:

*“Statutory general anti-avoidance rules, like judicial anti-avoidance doctrines, are uncertain in their scope and application. The words of the statute do not say with precision and in what circumstances tax will be imposed. This is hardly surprising. If Parliament could adequately describe in advance the circumstances in which tax would be charged, it would legislate to that effect. A general anti-avoidance provision attempts to deal with those actions that legislators cannot anticipate. At the same time, Parliament complicates matters further because it views some types of tax saving benevolently or even encourages certain action that has the effect of reducing tax liabilities. Where and how is the line to be drawn?”*

Both countries general anti avoidance rules are an admission by Parliament that general anti avoidance rules are designed to penalize activities that cannot be foreseen which is why it was not specifically legislated against.

## 5.3 The case for a general anti-avoidance rule

The TLRC criticised the ad hoc development of judicially developed anti-avoidance principles of statutory interpretation. Their recommendations were designed to provide a clear framework for the courts to develop appropriate principles of statutory interpretation. One of the strongest arguments for a general anti-avoidance rule is that it provides legislative authority for the courts to develop an anti avoidance strategy based on statutory criteria such as for example the mental state of the taxpayer, the objects of the transaction, an objective benefit test, or whether the transaction is an “abuse or misuse” of the legislation.

However the experience of the courts in Australia, Canada and New Zealand indicates that often those concepts are no easier to apply when they are contained in a statute as

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<sup>22</sup> *Structured finance and the operation of general anti-avoidance rules* Nabil Orow British Tax Review 2004 No 4 pp 410 - 436. See also the articles by Judith Freedman and John Tiley in the same edition.

<sup>23</sup> *Tax Avoidance and the Rule of law* edited by Graeme S Cooper (1997) IBDF Publications BV.

<sup>24</sup> *Tax Avoidance* published by The Tax law Review Committee Institute for Fiscal Studies November 1997 ISBN 1-873357-75-3.

opposed to judicially developed principles of statutory interpretation. The New Zealand experience suggests that the overriding aim of section BG 1 of the ITA is not to provide taxpayer certainty. The key features of the legislation outlined above clearly demonstrate that section BG 1 of the ITA does not contain any internal or external reference points that taxpayers can apply to ascertain whether the proposed transaction is likely to be caught. Lord Wilberforce raised this issue over thirty six years ago when he noted in *Mangin v CIR*<sup>25</sup> that section BG 1 of the ITA inter alia: “Fails to specify the relationship between the section and other provisions in the income tax legislation under which tax reliefs, or exemptions, may be obtained. Is it legitimate to take advantage of these so as to avoid or reduce tax? What if the only purpose is to use them? Is there any distinction between proper tax avoidance and improper tax avoidance? By what sense is this distinction to be perceived?”

The rationale is to legitimise what the New Zealand Courts are doing, which was a concern raised by Lord Hoffmann in *Westmorland Properties Ltd*<sup>26</sup> when he correctly said that the Courts do not have the constitutional authority to develop a judicial overlay to the specific tax laws that are in dispute. The court is limited to applying the conventional principles of statutory interpretation.

Critics<sup>27</sup> who reject the enactment of a general anti avoidance rule on the grounds that it is unlikely to provide certainty assume that is the paramount consideration. They are arguably focusing on the wrong test for determining the validity of a general anti avoidance rule. Tax legislation does not attempt to cover every conceivable permutation and the New Zealand experience with a general anti avoidance rule is that it authorises the courts to make assumptions about what rules a rationale Parliament would have enacted if it had specifically considered the actual transactions entered into by the taxpayer. The leading New Zealand cases which form the basis of this analysis illustrate the difficulty of foreseeing the techniques that taxpayers will use to get around or take advantage of a specific provision. From a constitutional perspective the enactment of a general anti avoidance rule is arguably preferable to judicial gymnastics which often involve repackaging the facts or interpreting specific words or phrases in a way that is said to be consistent with what a rationale Parliament is presumed to have intended but not specifically said so in clear unambiguous language.

The approach of the New Zealand courts to the application of section BG 1 of the ITA suggests that they have developed an interpretive approach which is consistent with a provision that authorises the courts to make assumptions about the legislative intent which is used to justify filling in the gaps in some situations. The technique is often difficult to apply and the application may lack clarity but it enjoys the important advantage over judicially created doctrines of fitting within the New Zealand constitutional model on the role of the courts

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<sup>25</sup> [1971] NZLR 591,601.

<sup>26</sup> [2001] 1 ALL ER 865, 874 paragraph 29.

<sup>27</sup> See for example P.Gillett [1999] BTR 1, E.Troup [1999] BTR 5, and more recently N. Orow [2004] BTR 410.

#### **5.4 Tax Laws are Often Incoherent.**

What happens when there is no clear legislative intention or the relevant rules are not coherent? This point was made by Richardson J. in *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 (CA) when he acknowledged that the scheme and purpose approach is not appropriate where the underlying tax law is incoherent or lacks a clear policy framework. He said at page 5,020:

*“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 argument that in many respects the tax base is so inconsistent and contains so many structural inequalities that a single general anti-avoidance provision such as [section BG 1 of the ITA] cannot be expected to provide an effective measure by which to weigh the exercise of tax preferences.”*

#### **5.5 Social and Economic Engineering.**

Tax law is not just about raising revenue. Income tax legislation is a method of achieving social and economic objectives. Prior to the Labour government’s reform of the tax system (1984 to 1990) the ITA contained numerous incentives to assist exporters and other selected sectors of the New Zealand economy. During that six year period most of the incentives were repealed. More recently (1999 to 2006) the Labour government has used the tax system to deliver significant amounts of welfare in the form of tax credits. Tax incentives are starting to re appear. For example the favourable changes to the taxation of venture capital and the proposed “kiwi saver” scheme are good examples. This type of legislation is designed to influence behaviour. Should a GAAR automatically apply to a taxpayer who deliberately seeks to take advantage of these provisions?

#### **5.6 Structural Choices.**

Finally the ITA contains clear alternative outcomes associated with simple transactions such as:

1. Buying and selling a business. There are significant tax consequences associated with the purchase of assets compared to the share capital of the asset owning company.
2. Financing the purchase (or expansion) of a business i.e. debt or equity.
3. What business entity or combination should be used to own the business? The options include sole trader, partnership, trust, joint venture and different types of companies.

This type of problem was highlighted by Richardson J. in *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 (CA) when he said at page 5,019 - 20:

*“...clearly the legislature could not have intended that section 99 should override all other provisions of the act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself ... seeking and taking advantage of incentives provided through the tax system designed to encourage particular economic activities could not be rejected out of hand as contravening the section. Yet in many cases, but for the anticipated*

*availability of the tax benefit, the taxpayer would have never entered into the activity or transaction. In more general terms such basic features as depreciation and trading stock valuations which are not tied for tax purposes to accounting or economic concepts, clearly allow for the deliberate pursuit of tax advantage”.*

This brief analysis of some of the theoretical issues, which surround the enactment, and interpretation of a GAAR such as section BG 1 of the ITA provide a helpful framework for examining whether the New Zealand judicial experience could provide an alternative interpretive approach to Part 1VA ITAA 1936.

## **6 An history of the Scheme and purpose approach to section BG 1 of the ITA**

### **6.1. CIR v Challenge Corporation Ltd.: The Origin of This Judicial Technique**

There is an uneasy relationship between Section BG 1 of the ITA and all the other provisions in the ITA. What is the relationship between Section BG 1, the core provisions, and specific tax regimes (such as trusts, partnerships, and Loss Attributing Qualifying Companies (LAQC)), and the remaining economic or incentive provisions left in the ITA? Richardson J in *Challenge Corporation Ltd* (1986) 8 NZTC 5,001 (CA) observed that:

*“On the other hand, [section BG 1 of the ITA] would be a dead letter if it were subordinate to all specific provisions of the legislation ... [section BG 1 of the ITA] thus lives in an uneasy compromise with other specific provisions of the income tax legislation. In the end, the legal answer must turn on an overall assessment of the respective roles of the particular provision and [section BG 1 of the ITA] under the Statute and of the relationship between them.” “... Thus, the concepts of tax, grouping and carry-forward of losses employed in ss 191 and 188 respectively of the Income Tax Act 1976 must be characterised as tax concepts. They have no reality under the Statute except in relation to income tax. In these circumstances it is difficult to discern any independent external yardstick of an overriding liability for income tax and the determination of the tax norms in this respect must turn on a close analysis of the specific provisions.”* (At pages 5,019-20 and 5,023 Emphasis added)

### **6.2 How does a New Zealand court apply the scheme and purpose approach?**

In *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 (CA) Richardson J said at page 5,020 that his approach to resolving the relationship between section BG 1 of the ITA and the other provisions relied on by the taxpayer essentially involves:

*“An overall assessment of the respective roles of the particular provision and [section BG 1 of the ITA] and of the relationship between them. That is a matter of statutory construction and the twin pillars on which the approach to Statutes mandated by sec 5(j) of the Acts Interpretation Act rest are the scheme of the legislation and the relevant objectives of the legislation. Consideration of the scheme of the legislation requires a careful reading in its historical context of the whole Statute, analysing its structure and examining the relationships between the various provisions and*

*recognising any discernible themes and patterns and underlying policy considerations.”*

Richardson J issued a word of caution that this is not a panacea for all potential problems when he said at page 5,020:

*“Certainly the scheme and purpose approach to statutory analysis will not furnish an automatic easy answer to these interpretation problems.”*

### **6.3. Three Main Categories**

In this important passage, Richardson J identified a number of different categories of legislation reflected in the ITA. There are at least three.

#### ***Category 1 – business concepts.***

Section BG 1 of the ITA is more likely to apply to an arrangement that involves ordinary business concepts of deductibility and assessable income. This is supported by an analysis of the leading anti-avoidance cases, which involve income-splitting arrangements (e.g. paddock trust cases or ‘contrived deductions’, which involve the insertion of additional legal entities such as a trust or partnership that provides an ‘essential input’ to the taxpayers business). That essential input is usually obtained from a related party, which enables the family entity to distribute income to take advantage of lower marginal rates of tax.

#### ***Category 2 – pure tax concepts.***

Richardson J appears to be suggesting that Section BG 1 of the ITA is less likely to apply if the arrangement is based around a tax concept, which has no underlying equivalent commercial basis. The clearest statutory examples are the loss carried forward and offset provisions contained in sections. IF 1 to IF 5 and Sections. IG 1 to IG 6 of the ITA, which are not reflected in any other commercial legislation such as the Companies Act 1993. Other important examples would include the clear tax advantages associated with the LAQC regime<sup>28</sup> and the previous trading stock regime, which allowed taxpayer’s to adopt cost, replacement, or market value. Note that for financial reporting purposes taxpayer’s are only permitted to adopt the lower of a cost or market value. A third well-known example would be the depreciation regime which permits taxpayer’s to depreciate ‘fixed life intangible property’ (FLIP) and to choose between the diminishing value and straight line methods.<sup>29</sup>

#### ***Category 3 – tax incentives.***

Very few incentive provisions remain in the ITA. They are confined to specific regimes such as the taxation of petroleum, mining and forestry.<sup>30</sup> However a recently released Discussion Document on options for business tax reform has floated the idea of a return to the “popular” business friendly tax incentives such as tax credits for money spent on “export market development expenditure” which was often used to

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<sup>28</sup> Refer to Part HG of the ITA for further details.

<sup>29</sup> Refer to Part EE of the ITA for further details.

<sup>30</sup> Refer to Part EJ of the ITA for further details.

defray part of the cost of discussing export opportunities with potential Australian customers at popular trans Tasman sporting events.

This approach to the application of Section BG 1 of the ITA enables the Courts to overcome the problems of adopting a literal interpretation, which would often produce results that could be inconsistent with the scheme of the ITA. For example, a taxpayer who deliberately takes advantage of a specific incentive should not be subject to Section BG 1 of the ITA because the ITA has been designed to encourage the very behavioural response that occurred. On the other hand, the ITA does not contain any features that suggest that the type of transactions that occurred in *O'Neil* should fall outside its ambit. Section BG 1 of the ITA was designed to attack that type of transaction, which contains tax, induced features that are the hallmarks of tax avoidance such as pretence and circularity, i.e. artificiality. If Section BG 1 of the ITA had applied to *Auckland Harbour Board*, it would have produced a result that was inconsistent with the specific provisions in the ITA which the taxpayer deliberately took advantage of.

#### **6.4. The New Zealand Concept of a Choice.**

This concept is linked to the scheme and purpose approach first mooted in *Challenge Corporation Ltd*. The judgments of both the majority and minority in *Peterson* are consistent with the concept of what is known as the New Zealand choice principle. This has an important implication that follows from the categories of legislation summarised above. The choice principle was endorsed by the Privy Council in *O'Neil*, and its New Zealand origins can be traced back to the judgment of Richardson J. in *Challenge Corporation Ltd*. The choice principle in the context of Section BG 1 of the ITA refers to a proposition, which originated in Australia that alternative courses of action provided for under specific provisions in the ITA are not automatically overruled by Section BG 1 of the ITA. The problem is that section BG 1 of the ITA does not contain any statutory guidance on how the open ended test is to be modified by the Courts to take account of arrangements were a taxpayer has simply exercised choice expressly made available to him by Parliament.

This issue is less likely to arise in the Canadian context because section 245 of the CITA contains an abuse or misuse test which provides those courts with a statutory authorisation to consider if the taxpayers arrangement amounts to a misuse of an incentive provision. A good example is recent decision of the Supreme Court of Canada in *The Queen v Canada Trustco Mortgage Co*<sup>31</sup>.

The leading Australian cases include:

1. *W P Keighery v FCT*;<sup>32</sup>
2. *Casuarina Pty Ltd v FCT*;<sup>33</sup>
3. *Mullens v FCT*;<sup>34</sup>

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<sup>31</sup> 2005 SCC 55.

<sup>32</sup> (1957) 100 CLR 66.

<sup>33</sup> 71 ATC 4068.

<sup>34</sup> (1976) 135 CLR 290.

4. *Slutzkin v FCT*;<sup>35</sup> and
5. *Cridland v FCT*.<sup>36</sup>

In *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 (CA), Richardson J. discussed with approval the above Australian cases and summarised their applicability in New Zealand as follows:<sup>37</sup>

*“It is the principle which is important and Keighley provides powerful support for the proposition that to do no more than adopt a course which the Act specifically contemplates as effecting a tax change does not alter the taxpayer's liability for income tax in the statutory sense and does not result in an alteration in the incidence of income tax contemplated by the Act”.*

This approach is particularly important when considering the potential application of category two (pure tax concepts) and category three (incentive provisions) legislation of Section BG 1 of the ITA

## **7 The New Zealand judicial approach to the pre 1974 general anti avoidance rule**

Section 108 of the LITA 1954 had a slow start and only became a popular weapon with the CIR in the mid 1960s.<sup>38</sup> Unlike what happened in Australia the New Zealand courts gave this provision a broad interpretation.

A typical decision is the approach taken by the Court of Appeal and Privy Council in *Mangin v CIR*[1971] NZLR 591. The taxpayer was a farmer who farmed 385 acres of land. In 1965 in an attempt to avoid the impact of the graduated rates of personal income-tax, he created a “paddock trust”. Under that arrangement he leased 25 acres for one year at 3 pounds an acre to the trustees who were to cultivate it. Pursuant to the terms of a separate deed, the income was held on trust for the taxpayer's wife and children. The taxpayer was employed by the trustees to sow, harvest, and sells the crop and account for the sale proceeds to the trustee. The taxpayer was paid by the trustee for his labour and all expenses incurred in growing and harvesting the crop. The following year the taxpayer entered into a similar arrangement in relation to a different 24 acre paddock. The Commissioner set aside the transactions on the grounds that section 108 of the LITA applied.

The majority of the Privy Council upheld the Commissioner's assessment. The majority relied on the fact that each of the leases was for only one year and that the actual land leased differed from year to year. The majority noted that the rent was inadequate and that the taxpayer effectively undertook all of the same activity which had occurred prior to the lease. These features meant that when applying *Newton* the arrangements could be labelled as a means of avoiding tax. In view of subsequent

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<sup>35</sup> (1977) 140 CLR 314.

<sup>36</sup> (1977) 140 CLR 330.

<sup>37</sup> (1986) 8 NZTC 5,001 at pg. 5,023.

<sup>38</sup> In *Challenge* Richardson J noted at pp 5,017 that ‘Within a span of 12 years from the mid-19 60s to the mid-19 70s, section 108 was argued for times the Privy Council and in some 50 cases in the courts and board of review in New Zealand.’

judicial developments in New Zealand it is interesting to note that the majority did not consider the *Purcell/Clarke/Keighery* principle.

## **8 The Australian approach to section 260**

The traditional attitude of the courts to section 260 was that it did not apply where a specific provision had an overriding force, or where the incidence of taxation was that which was contemplated or intended by the ITAA 1936. This principle was first established in *Purcell*, and developed in *Clarke*.

*WP Keighery Pty Ltd* is an important application of this principle because it is relied upon by Richardson J. in *Challenge Corporation Ltd*. That case arose because private companies paid undistributed profits tax unless they distributed the specific proportion of their taxable income. Accordingly there was an incentive for a private company to become a public company while at the same time, remaining under the control of a comparatively small number of shareholders. The relevant legislation, Division 7 of Part 2 gave each company a choice whether it had to bear undistributed profits tax as a private company or satisfy the conditions to become a public company. This choice was intended to be available even where it was exercised mainly to reduce the potential incidence of this tax. In *Keighery's* case a single redeemable preference share was allocated to an additional eight shareholders which gave the company public status but effective control remained on the hands of the original shareholders. The High Court noted that the very purpose or policy of division 7 was to present the choice to a company between incurring the liability which was provided for, or taking measures to enlarge the number of shareholders who controlled the company's affairs. To choose the latter course, the court said could not be to defeat, evade or avoid a liability imposed by the ITA 1936 or to prevent the operation of the ITAA 1936. That approach is similar to the scheme and purpose approach, and it is interesting to note that in paragraph 6.4 Richardson J specifically cited with approval this case in support of his interpretive technique.

The highly or low water mark of the application of the choice principle was *Cridland*. That case involved a scheme which was designed to take advantage of income averaging rules which were intended to assist pastoral farmers. A unit trust was established which carried on a modest business of pastoral farming. The trust issued shares for one dollar to hundreds of university students in order to enable those students to enjoy the tax preferred status of primary producers. The High Court of Australia refused to apply section 260.

## **9 Application of section 260 to Mangins case**

In view of the approach taken by the High Court of Australia in *Cridland v FCT* it is difficult to envisage the CIR succeeding if this case had been ultimately determined by that court. In *Cridland* the High Court held that *Keighery's* case was not to be narrowly construed. Accordingly a university student could create a situation by entry in to a transaction which would have attractive tax consequences and that section 260 could not apply to such a taxpayer because he enters into the transactions deliberately with a view to gaining that advantage

With respect, that approach involves turning both *Newton* and *Keighery* upside down. In *Newton* Lord Denning accepted that the taxpayers action in *Keighery* did not by itself trigger the application of section 260. Lord Denning considered *Newton* was altogether different which is why the taxpayer ultimately lost. In *Keighery* there was no suggestion that the shareholders did not purchase their single preference share. Nor was it suggested that they do not follow the terms of their agreements. Thirdly it was the company itself who status was an issue on a particular day which the ITAA 1936 prescribed as the bright-line test. Contrast those facts with what occurred in *Cridland*. The taxpayers in *Cridland* could not under the terms of the trust deed become an income beneficiary unless he donated at least one dollar to a fund which had been approved by the student body. He did not in fact make that payment. Secondly he also agreed to pay a fee which would be calculated by reference to his tax saving. The marketing pamphlet stated that the fee was not legally recoverable and that the promoters were relying on the honesty of the beneficiaries. No such fee was ever paid by Mr Cridland. Thirdly the taxpayer agreed that he did not expect to receive any distributions from the trust. His purpose was to achieve the income averaging on his other income relying on the averaging provisions of Division 16 of the ITAA 1936. All of this non-compliance was ignored by the Mason court.

In view of the fact that individuals are taxed on graduated rates of tax, whereas trustee income and company income is taxed at a lower flat rate, it is more likely than not that the Mason court would have viewed the paddock trust arrangement as nothing more than a taxpayer creating an advantage which was implicitly contemplated by these features of the ITA. This conclusion is supported by the fact that the High Court in *Cridland* did not discuss the policy for income averaging farmers outlined in Division 16 and what was the reason which lay behind the specific rule contained in section 157(3).

## **10 Application of the pre 1974 New Zealand approach to *Cridland v FCT***

The absence of any discussion by the Privy Council in *Mangin* of the Australian concept of a choice prior to the decision in *Challenge Corporation Ltd* suggests that the outcome would have been different if that case had been ultimately decided by the Privy Council.

The ultimate success of the scheme in *Cridland* depended upon how the court would interpret the key provision section 157(3) which provided that:

*“for the purposes only of determining whether a person is carrying on a business of primary production, a beneficiary in a trust estate shall, to the extent to which he is presently entitled to the income or part of the income of that estate, be deemed to be carrying on the business carried on by the trustees of the estate which produces that income”*.

The High Court in *Cridland* did not discuss the policy for income averaging or what were the reasons for the trust rule summarised above. The willingness of the Privy Council to adopt a more literal approach to the application of section 108 of the LITA 1954 strongly suggests that the Privy Council would have been unlikely to extend the *Keighery* principle to the circumstances outlined in *Cridland*. Section 157(3) is

essentially a machinery provision. Division 16 is clearly designed to allow taxpayers who carry on the business of primary production to average their incomes. Obviously difficulties arise in the case where the farm is owned by and the farmer/taxpayer is a trustee. Secondly the beneficiary does not carry on the business of primary production and therefore Division 16 would not apply where the business was being carried on by a trustee of trust on behalf of a beneficiary. It was to overcome these types of problem that section 157 (3) was enacted. It is stretching the *Keighery* principle too far to suggest that the ITAA 1936 via a machinery provision created or presented taxpayers such as Mr Cridland with the choice of entering into the highly artificial arrangement to clothe them in the characteristics of a primary producer.

If the High Court of Australia had applied section 260 in *Cridland* would have amounted to little more than applying the “**frustration**” limitation noted in *Keighery* where it was said:

*“[Section] 260...intends only to protect the general provisions of the Act from frustration and not to deny to taxpayers any right of choice between alternatives which the Act itself lays open to them”* (Emphasis added).

This sound very similar to the category one and two classification developed by Richardson J in *Challenge Corporation Ltd*. In terms of *Newton* it is highly likely that the Privy Council would have concluded that what occurred were not transactions ordinarily entered into by university students and could not be classified as ordinary family or business dealing. They were only explainable by reference to a desire to attract the tax saving associated with the averaging provisions contained in Division 16 of the ITAA 1936, which were intended to apply to “real” farmers and not to university students.

In view of the conceptual difficulties created by the application of a general anti-avoidance rule, it is possible to sympathise to some extent with the dilemma faced by the High Court in *Cridland*. As in *Keighery's* case, the taxpayer was deliberately seeking to take advantage of a preference that created by the ITAA 1936. The High Court had to decide on the basis of a yes or no answer. The ultimate question was as identified in *Keighery* about frustration of the relevant underlying policy. Is that what the ITAA 1936 meant when it enacted section 157(3) which is prima facie an essential **machinery provision** that is designed to do nothing more than solve the technical difficulty created by the legal distinction between the business carried on by a trustee and the beneficial owner of the income arising from that business. One is left with the overall impression that the High Court of Australia by the time the *Cridland* case arose had given up on attempting to answer this type of question, which did not occur in the New Zealand cases decided under section 108 of the LITA 1954.

## **11 The 1974 amendment: the current section BG 1 of the ITA, and the origins of the scheme and purpose approach**

### **11.1 Judicial concerns at the constitutional dilemma created by section 108 of the LITA 1954**

The 1974 amendment in part reflects the criticisms made by McCarthy P in *CIR v Gerard*<sup>39</sup> who addressed the New Zealand Parliament in his judgment noting that it was an unworkable provision which had been described by the trial judge as operating in “a world of fiscal phantasy”. McCarthy P. said in his opening paragraph:

*“The section is notoriously difficult. It cannot be given a literal application, for that would, the Commissioner has always agreed, result in the avoidance of transactions which were obviously not aimed at by the section. So the courts have had to place glosses on the statutory language in order that the bounds might be held reasonably fairly between the Inland Revenue authorities and taxpayers. But no one's suggests that this is satisfactory, especially as one result has been that the Privy Council **has been forced in a number of cases to assume the tasks, rightly one for the legislature, of providing the tests according to which our people are to be taxed. As Wilson J. points out, arguments on the application of section 108 are now rarely, if ever based on the text of the section itself; they are mainly, if not wholly, centred on the glosses placed by the courts on the text.**”* (Emphasis added).

Unlike the Australian judges the New Zealand courts never gave up on trying to make the section work. For example in *Cridland*<sup>40</sup> Mason J picked up on the earlier advice of Kitto J in *Newton* who said that section 260 was a:

*“Difficult provision, inherited from earlier legislation, and long overdue for reform by someone who will take the time to analyse his ideas and define his intentions with precision before putting pen to paper”.*

Mason J noted that:

*“This message, despite as clarity, seems not to have reached its intended destination.”*<sup>41</sup>

On 23 July 1974 the New Zealand Minister of Finance introduced an amended version of section 108 of the LITA 1954, which became section BG 1 of the ITA. In the course of his opening speech the Minister of Finance said that the proposed amendment:

*“...follows recent criticism of the present section in the courts”.*

### **11.2 The legislative hoax**

For the purposes of this article the two main changes made by the New Zealand Parliament to section BG 1 of the ITA were:

1. It removed the sole or principal purpose test developed by the majority in *Mangin* and also the so-called Newton predication test (ie the fact that an

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<sup>39</sup> [1974] 2 NZLR 279.

<sup>40</sup> 96 CLR 578, 596.

<sup>41</sup> (1977) 140 CLR 330, 338-339.

arrangement was explicable and referable to “*ordinary business or family dealing, without necessarily being labelled as a means to avoid tax*”). The new section will operate against “any purpose or effect” of “tax avoidance” unless that purpose or effect was merely incidental.

2. The amendment defined “arrangement” by adopting verbatim the words of Lord Denning in *Newton*.

The only internal and external statutory reference point is the incidental purpose test. Section BG 1 of the ITA does not answer the crucial question of what happens if a tax payer deliberately takes advantage of a tax preference. Regretfully Parliament made no attempt whatsoever to analyse the relationship between section BG 1 and structural choices contained within the ITA such as incentive provisions, social provisions, and tax constructs which bear no relationship to commercial reality. Once again the New Zealand courts were left with the dilemma of trying to apply an amended provision which still could not be given a literal interpretation or application. It would not be an exaggeration to describe the post 1974 amended anti avoidance rule as a legislative hoax.

### **11.3 Challenge Corporation: the origins of scheme and purpose**

This case involved a very simple transaction which was only undertaken to obtain a tax advantage. Shares in a loss company were acquired by the taxpayer Challenge Corporation before midnight on 31 March, which under the grouping provisions at that time, was the only time at which it was determined whether or not companies were in a group and ostensibly able to offset profits and losses. The taxpayer acknowledged that the acquisition of the loss company was undertaken to acquire the losses and not for any other business purpose.

Accordingly the purchase price was \$10,000 or 22.5 per cent of the available tax losses of \$5.8 million which had been incurred by Loss Co. The transaction was structured as an outright purchase of shares to avoid the application of a specific anti avoidance provision which dealt with temporary acquisitions of shares in a company in order to include that company in a group.

Richardson J focused on the fact that the case involved a simple transaction. All that occurred was that shares were purchased by a particular date and certain inevitable tax consequences followed. The presence of provisions such as section 191 of the ITA 1976 could only be explained in terms of Parliament’s intention to pierce the corporate veil and permit groups of companies which existed on a particular date to offset losses against profits. Richardson J concluded that the Commissioner could not invoke section BG 1 of the ITA because the ITA contemplated the income tax consequences of the transaction. The fact that the sole purpose of the transaction was to minimise the overall tax liability of the taxpayer’s new group was not a sufficient reason to invoke section BG 1 of the ITA because that is the only reason why loss and profit companies agree to subvention payments. This analysis has subsequently become known as the scheme and purpose approach where the application of section BG 1 is based on an interpretation of all of the relevant provisions, to ascertain if there is any underlying policy, and come to a conclusion on that basis.

Richardson J analysed the history of the grouping and loss carry forward rules commencing with the Land and Income-Tax Act 1922. He noted that the 1968 amendment introduced a comprehensive scheme for loss offset within groups of companies. The statutory test focused on the common shareholding between the two companies and was based on a test which had to be satisfied on the last day of the income year. The inevitable conclusion which he reached from this approach was:

*“The nature of section 191 and these features of the scheme of the section at the material time do not in my view leave any room for the application of section [BG 1] to these straightforward arrangements which do no more than bring the loss companies within a new group so as to satisfy all of the requirements of section 191. It is no answer to say that the purpose of the arrangement was to save tax for this is the purpose of every offset of a loss of one company against a profit and another, which is the only reason for the presence of section 191 in the statute. **The liability for income tax that arises through the carrying out of the transaction is the liability which is contemplated by the Act.**”* (Emphasis added)

He concluded his judgement by noting:

*“On the analysis of the role of section 191 in the statutory scheme, and of the terms of the provision itself, I am satisfied that to treat the arrangements carried out in this case as tax avoidance within section [BG 1] would defeat, not promote, the legislative purpose involved. **The tax changes achieved in the transactions did not alter the incidence of income-tax which the Act itself contemplated or affect Challenge’s liability for income tax in the sense indicated by the Statute.**”* (Emphasis added)

This has to be the correct approach because clearly a subvention that payment has no “natural” order or commercial reality. It is the creation of the ITA itself because it is subject to rigid specific rules which must be strictly complied with. It is a self-contained code within the loss-offset provisions in the ITA, which in turn have a specific anti avoidance rules.

## **12 Recent examples of the Scheme and purpose approach**

### **12.1. CIR v BNZ Investments Ltd.**

Fifteen years after Challenge Corporation Ltd, Richardson J repeated his approach in *BNZ Investments Ltd*. Given what happened in *Auckland Harbour Board*, and the rejection in *O’Neil* of tax mitigation, and the adoption by both the majority and minority in *Peterson* this has become the decisive interpretative technique. In *BNZ Investments Ltd*, Richardson J observed that<sup>42</sup>:

*“The function of [section BG 1 of the ITA] is to protect the liability for income tax established under other provisions of the legislation. The fundamental difficulty lies in the balancing of different and conflicting objectives. Clearly the legislature could not have intended that [section BG 1 of the ITA] should over-ride all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided by the Act itself. Equally the general anti-avoidance provision cannot be subordinated to all the specific provisions of the tax legislation. It, too, is specific in the sense of being specifically directed against*

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<sup>42</sup> (2001) 20 NZTC 17,103, Para. 40 at pg. 17,115.

*tax avoidance; and it is inherent in the section that, but for its provisions, the impugned arrangements would meet all the specific requirements of the income tax legislation. The general anti-avoidance section thus represents an uneasy compromise in the income tax legislation.”*

## **12.2. CIR v Auckland Harbour Board.**

*Auckland Harbour Board* is another important example. It can only be explained in terms of the category of legislation the Privy Council were considering. On any other form of analysis the CIR should have won.

Why did the IRD lose? A plausible explanation is that the taxation of financial arrangements is category two legislation (ie pure tax concepts) and taxpayers are free to exploit any loopholes. It was as blatant as what happened in *Challenge Corporation Ltd*, yet the CIR lost. The key steps in Lord Hoffmann’s judgement in *Auckland Harbour Board* can be seen in the following propositions:

1. The financial arrangements were taxable in accordance with a comprehensive statutory regime.
2. The traditional legal approach to the taxation of this type of financial instrument has been replaced by an economic concept of income and expenditure associated with a debt instrument.
3. A key component is the wash up calculation known as the base price adjustment, which is determined in accordance with a number of statutory formulas and related definitions.
4. The CIR accepted that the loss arising from the gift was an automatic deduction under the statutory formula.
5. The CIR accepted that the legislation contained no over riding discretions.
6. The CIR argued that to allow the taxpayer to claim the deduction for the loss created by the gift would frustrate Parliaments intention and therefore section BG 1 of the ITA must apply.

Lord Hoffman dealt with this submission by applying the Challenge methodology. He said:

*“Their Lordships consider that the only way to test this submission is to inquire into what parliament has expressed itself, properly construed according to currently adopted notions of how a taxing Act should be interpreted and with due regard to s 5(j) of the Acts Interpretation Act 1924 as amended. At this point it appears to their Lordships that Mr Jenkins was faced with a logical difficulty. He concedes that, giving s 64F the liberal construction which the Interpretation Act requires, reading it in the context of the general scheme of the accrual regime, in the purposive spirit prescribed by Challenge Corporation Ltd v CIR and with the best will in the world, it is not possible to read the section as requiring anything other than the actual consideration to be used as part of the formula for calculating the base price adjustment. If the consideration is nil, that is the figure to be inserted... Such a transaction either attracts a deduction or it does not. The Commissioner accepts that it does, but claims the right under s 64J (1) to be able to amend the law to ensure that it does not. Their Lordships do not think that the section was intended to confer such a power. It would amount to the imposition of tax by administrative discretion instead of by law.”* (At. pages 299-300).

### 12.3 O'Neil v CIR

The CIR was successful in applying section BG 1 of the ITA to a highly artificial arrangement that involved a temporary sale of a profitable business to a dormant tax loss company. After the losses had been utilised, the loss company sold the profitable company back to the original owners who continued to run the profitable company throughout the duration of the scheme. The Privy Council had little doubt that it amounted to an arrangement, which had the purpose or effect of tax avoidance within the meaning of section BG 1 of the ITA. It was not possible for the taxpayer to realistically argue that the tax advantage was primarily incidental to obtaining tax and financial advice from the Loss Company.

The advice of the Privy Council was delivered by Lord Hoffmann, who recognised category one (business concepts) legislation in these terms:<sup>43</sup>

*“In many (though by no means in all) cases, the legislation will use terms such as income, loss and gain, which refer to concepts existing in a world of commercial reality, not constrained by precise legal analysis...Their Lordships consider this [category one] to be a paradigm of the kind of arrangement which section [BG 1] was intended to counteract.”*

Lord Hoffman then noted the contrast between the category one and category two (pure tax concepts) and category three (tax incentives) legislation in these terms:

*“On the other hand, the adoption of the course of action which avoids tax should not fall within section [BG 1] if the legislation, upon its true construction, was intended to give the taxpayer of the choice of avoiding it in that way.”*

There were no general or specific provisions in the ITA which the taxpayer could point to that sanctioned this type of artificial transaction. This case is an example of when the courts can apply a literal interpretation to the application of section BG 1 of the ITA

### 12.4 Peterson v CIR

The real significance of the decision lies in the fact that there was agreement by both the majority and the minority on a number of important issues, which are consistent with the earlier judgement of Richardson J in *Challenge Corporation Ltd* and later decisions of the Privy Council and Court of Appeal discussed above. Section BG 1 of the ITA cannot be read literally. Taxpayers are entitled to structure their affairs to take advantage of structural choices and economic incentives contained in the ITA. Both judgements endorsed the “scheme and purpose approach” to the interpretation of the general anti-avoidance rule, which is based on the legislative pattern

The majority and minority judgments agreed that the CIR could not adopt a literal interpretation of Section BG 1 of the ITA. The application of general anti-avoidance rule depends on whether or not it would be consistent with the scheme and purpose of the ITA and in particular, the different categories of legislation reflected in the ITA.

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<sup>43</sup> (2001) 20 NZTC 17,051, Para. 10 at pg. 17,057.s.

This approach had been followed by the Privy Council in the two earlier cases of *Auckland Harbour Board*<sup>44</sup> and *O'Neil*.<sup>45</sup>

In *Challenge Corporation Ltd*, Richardson J said<sup>46</sup>:

*“Clearly the legislature could not have intended that section [BG 1] should override all other provisions of the Act so as to deprive the taxpaying community of structural choices, economic incentives, exemptions and allowances provided for by the Act itself.”*

This passage was cited with approval in the minority judgment of Lord Bingham of Cornhill and Lord Scott of Fossette.<sup>47</sup>

The majority and minority judgements both agreed that the taxpayer obtained an advantage from the arrangement in the form of the depreciation deduction, which reduced their liability to pay tax. However, that was an insufficient reason for invoking Section BG 1 of the ITA. Lord Millet said<sup>48</sup>:

*“The critical question is whether the tax advantage which they obtain amounted to tax avoidance capable of being counteracted by section [BG 1], for the Courts of New Zealand have long recognised that not every tax advantage comes within the scope of the section; only those which constitute tax avoidance as properly understood do so.”*

Lord Millet<sup>49</sup> has endorsed an important observation of Richardson J in *Challenge Corporation Ltd* that it:

*“...was obviously never intended that transactions should be struck down merely because they were influenced by the prospect of obtaining a tax advantage. In many cases, but for the anticipated availability of a tax benefit, the taxpayer would never have entered into the transaction at all. Basic features of the tax systems such as depreciation and trading stock valuations, he said, clearly allow for the deliberate pursuit of tax advantage.”*

The minority endorsed this approach by referring to the quotation from *Challenge* noted above.

The approach of both the majority and minority is entirely consistent with the earlier decisions of the Privy Council in *Auckland Harbour Board* and *O'Neil*. This approach is also supported by the earlier decision of the Privy Council and the Court of Appeal in *Challenge Corporation Ltd*. The origin of this approach is the judgment of Richardson J. in *Challenge Corporation Ltd*, which provided a conceptual framework for distinguishing between legitimate and illegitimate tax planning. This approach provides an objective standard which both the CIR and taxpayers can apply to a potential transaction.

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<sup>44</sup> The *Auckland Harbour Board* facts are summarised at 3.5.

<sup>45</sup> The *O'Neil* facts are summarised at 3.3.

<sup>46</sup> (1986) 8 NZTC 5,001 at pg. 5,019.

<sup>47</sup> (2005) 22 NZTC 19,098 per Lord Millet, Para. 61 at pg. 19,119.

<sup>48</sup> (2005) 22 NZTC 19,098, Para. 35 at pg. 19,109.

<sup>49</sup> See n.48, Para. 36 at pg. 19,109.

## **13 Application of the scheme and purpose approach to the recent decisions of the High Court of Australia**

### **13.1 FCT v Spotless Services Ltd**

From a New Zealand scheme and purpose perspective one of the difficult aspects of this case is why did the High Court appear to ignore the fact that the transaction was structured to take account of a tax preference? This case is conceptually similar to *BNZ Investments Ltd* which involved a scheme that was deliberately structured to take advantage of two unusual provisions which created a statutory mismatch. From a scheme and purpose perspective the case would have been analysed and probably decided differently

The taxpayer had received substantial funds from a public float which it did not require in the short-term. After evaluating a number of short-term investment options the taxpayer chose to deposit the proceeds in a Cook Islands interest bearing account which was subject to a low rate of Cook Islands withholding tax. The taxpayer knew that the then section 23q of the ITAA 1936 provided that foreign sourced income would be exempt from Australian tax if it had been subject to tax in an overseas jurisdiction. There was no requirement that for example the amount of tax had to be comparable to the rate of Australia tax which would have been paid on an Australia deposit. Secondly withholding tax qualified as overseas tax. The interest rate paid on the Cook Islands deposit was 4% less than the comparable interest rate which would have been paid on a similar deposit in Australia. However the Australian source interest would have been subject to a higher rate of tax. Accordingly the after-tax return on the Cook Islands deposit was higher than the equivalent Australian comparable after tax return because of the lower rate of withholding tax imposed by the Cook Islands.

In a well known passage the High Court said references:

*“on the one hand to a “rational commercial decision” and on the other to the obtaining of a tax benefit as “the dominant purpose of the taxpayer making the investment” suggest the acceptance of a false dichotomy. A person may enter into or carry out a scheme within the meaning of Part IVA for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business. A particular course of action may be, to use a phrase found in the Full Federal court judgements both “tax-driven” and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Part IVA, a person entered into or carried out a “scheme” for the “dominant purpose” of enabling the taxpayer to obtain the “tax benefit”.<sup>50</sup>*

Under that approach it is not simply a matter of weighing up the commercial advantages of the scheme and contrasting them against the tax advantages to ascertain whether it is possible to view the scheme as an ordinary commercial transaction which

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<sup>50</sup> FCT v Spotless Services Ltd (1996) 34 ATR 183 at 187-188.

was undertaken in the most tax effective manner ie by taking advantage of section 23q. Once it is accepted the tax considerations shape every transaction the High Court seemed to have concluded that there is no real dichotomy between the pursuits of a commercial gain on the one hand and obtaining a tax benefit on the other. If the commercial benefit is dependant on the tax benefit the High Court appear to be saying that it is not correct to say that the dominant purpose was to obtain the commercial benefit. Consequently Part 1VA will apply because the taxpayer entered into the scheme for the dominant purpose of obtaining a tax benefit even though the benefit was specifically contemplated by the ITAA 1936. Or to put it another way is it not possible to enter into a transaction which is deliberately designed to obtain a tax benefit specifically provided for in the ITAA 1936 if the commercial advantage of the scheme is will only arise because of the tax benefit. To do so will expose the taxpayer to Part 1VA of the ITAA 1936.

The New Zealand scheme and purpose approach solves that dilemma. The *Spotless* case revolved around a commercial transaction which involved a decision to adopt a particular investment strategy which deliberately took advantage of a specific tax concession granted by the ITAA 1936. Under the scheme and purpose approach a taxpayer is entitled to take tax considerations into account when considering and implementing a business transaction. Accordingly the taxpayer in *Spotless* would have been entitled to implement a strategy which took advantage of the exemption from Australian tax for all income which had been subject to foreign tax. The fact that the money was taken off deposit in Australia and placed on deposit overseas would not have been relevant because a mere change in an investment would rarely lead to the conclusion that it was done solely for tax reasons. The fact that the deposit of funds in the Cook Islands was accompanied by additional security documentation which was designed to reduce the credit risk associated with the Cook Islands financial institution would not have been a material factor because there is nothing in section 23q which dealt with this type of commercial consideration.

It is interesting to speculate what would have happened if the taxpayer had invested the money in a alternative Australian tax exempt activity such as a gold mining operation which also would have produced exempt income. Presumably Part 1VA ITAA 1936 would have applied. Yet in each case, the dominant purpose of the investor is to obtain the maximum return on the money invested after the payment of all applicable costs including tax. Under the scheme and purpose approach taxpayers are entitled to deliberately structure their investment decisions to take advantage of tax preferences.

### **13.2 FCT v Consolidated Press Holdings Ltd**

Similar concerns arise if the scheme and purpose perspective is adopted. However unlike *Spotless* there was no specific statutory provision which the taxpayer sought to take advantage of. It would appear that the scheme was designed to avoid the negative impact of section 79D and at the same time satisfy the ordinary test of deductibility contained in section 51(1) of the ITAA 1936. This was achieved by the taxpayer arranging to use the borrowed money to subscribe for shares in another Australian company MGL which used the proceeds of the share issue to CPH to take up preference shares in a United Kingdom company CPIL (UK). The insertion of

MGL was designed to circumvent section 79D which would have quarantined the interest deductions against the anticipated (if any) United Kingdom dividends

From a scheme and purpose perspective this additional step would probably be viewed as a relatively uncomplicated case of little more than a taxpayer structuring a genuine off shore take over to achieve an interest deduction. The case is not dissimilar to the structuring which occurred in *Peterson*, and *BNZ Investments Ltd*.

### **13.3 FCT v Hart**

This is the most difficult of the three case to apply the scheme and purpose approach to because the scheme did not take advantage of any specific provision in the ITAA 1936, or as in *Consolidated Press* attempt to get around a specific provision which placed a restriction on the ordinary rule contained in section 51(1) of the ITAA 1936.

Despite the clear indication in the EM that Part 1VA ITAA 1936 was intended to restore the position to the interpretation of the old section 260 established in *Newton* the High Court in *Spotless* and *Consolidated Press* rejected the predication test because it introduced a false dichotomy. The fallacy was that a taxpayer who acted in a commercially rational manner could well have done so with the dominant purpose of also obtaining a tax advantage.

This approach was confirmed and again applied in *Hart* to a case which seemed to be far from the boundary between 'blatant, artificial, or contrived' schemes and a case where a taxpayer merely adopted one of two or more courses of action, which happened to contain the lowest overall tax cost.

The scheme and purpose approach does not seek to identify whether any tax advantage can be classified as the dominant purpose. This approach is designed to apply the New Zealand equivalent test (is the tax advantage more than merely incidental) in a manner that is consistent with the relationship (if any) between the various provisions and any underlying policy considerations. Cases such as *O'Neil* clearly demonstrate that this approach can combat the type of schemes identified in the EM. It would also combat what occurred in *Cridland*.

In the context of this case the scheme and purpose approach would focus on the fact that the legislative provision relied on by the taxpayer was the general test of deductibility, which was been relied on to implement a genuine commercial borrowing. The tax advantage would probably be viewed as merely incidental to the transaction.

## **14 Implementation of the New Zealand scheme and purpose approach**

### **14.1 The statutory basis of the scheme and purpose approach**

If the High Court of Australia were to adopted the New Zealand scheme and purpose approach to Part 1VA ITAA 1936 would the statutory tests and the statutory language

prevent its implementation? This may not be a significant issue because the New Zealand approach is not based on any specific statutory authorisation. There are no words or phrases in section BG 1 of the ITA which has been relied on by the New Zealand courts to justify this approach. It arose from the 1974 amendment which replaced the Newton Predication test with the current “more than incidental” tax benefit test. The New Zealand courts were once again left with the dilemma of adopting a literal interpretation or reading it down and if so how would that be achieved.

#### **14.2 Challenge Corporation Ltd: subvention payments and scheme and purpose**

Sections IG 1 to IG 10 of the ITA allow for a profit company to make a tax deductible payment to loss company which is a member of the same group of companies. There can be only reason for making such a payment and that is to use the language contained in the definition of “tax avoidance” to alter the incidence of any income tax by relieving any person from liability to pay income tax. This is one of the clearest examples of an arrangement that is squarely caught by a literal application of section BG 1 of the ITA yet the CIR does not invoke it against conventional subvention payments.

The answer lies in the analysis of Richardson J in *Challenge Corporation Ltd*. His Honour noted that the 1974 amendment only addressed two of the concerns raised by Lord Wilberforce in *Mangin*. Parliament had not addressed the difficult question of the relationship between section BG 1 of the ITA and the various provisions in the ITA which create tax relief or exemptions and what happens when a taxpayer deliberately arranges their affairs to take advantage of them? He commenced his answer to this question by nothing on page 5,019 that a taxpayer who does so: “*is not saved by the old predication test of ordinary business dealing if any purpose other than a merely incidental purpose is tax avoidance*”

He then provided the answer to question raised by Lord Wilberforce which had been ignored by Parliament and at the same time provided the constitutional rationale for his solution which was:

“*...In these circumstances it becomes particularly important to determine the relationship between [section BG 1 of the ITA] and other specific provisions in the legislation under which tax changes may occur. **The legislation having failed to provide specific tests in this regard, it falls to the Courts to do so as a matter of statutory construction***” (emphasis added).

This important passage from his Honours judgement clearly demonstrates that the development of the scheme and purpose approach was not based on any legislative direction. Rather it was the absence of any legislative solution to the problem of tax preferences, tax incentives, and pure tax concepts which left the Court with no choice but to once again make the section work.

### 14.3 Section 177C (2) of Part 1VA ITAA 1936.

Section 177C (2) provides that a “tax benefit” does not arise from making a:

- Agreement,
- A choice,
- A declaration,
- A election,
- A selection,
- A notice or option,

this is expressly provided for by the ITAA 1936. However this escape hatch does not apply if the scheme was entered into for “the purpose of creating any circumstance or state of affairs”.

This provision could be used as the statutory mechanism to introduce the New Zealand approach. However the limited judicial analysis to date has tended to limit the potential ambit of section 177C (2) rather than interpret it in an expansive way. For example in *Case W 58*<sup>51</sup> the Tribunal held that the mere existence of specific rules governing the taxation of trusts should not be taken as choice “expressly provided for” by Act which could be used to justify income splitting schemes.

### 14.4 Dominant purpose test

If there was a desire to adopt the scheme and purpose approach the dominant purpose test would appear to provide the High Court with a judicial mechanism to do so. The emphasis on the false dichotomy could be played down in cases such as *Spotless Services* where a genuine commercial transaction is merely structured to take advantage of a tax benefit specifically provided for by the ITAA 1936.

## 15 Conclusions

Despite the EM the High Court have consistently adopted an approach to Part 1VA ITAA 1936 which does not distinguish between the tax effective implementation of an ordinary commercial transaction and “blatant, artificial, or contrived” schemes. Nor is particularly clear the extent (if any) to which a taxpayer can implement a commercial transaction by adopting the least expensive tax option.

It would appear that the taxpayers in *Spotless*, *Consolidated Press* and *Hart* all crossed an almost invisible line because in each case the commercial benefits were dependant on the taxpayer obtaining a tax benefit. Or to put it another way without the tax benefit the scheme would not have been entered into in that way which means a taxpayer cannot insert steps into a scheme that are only designed to achieve a tax benefit. *Spotless*, (and to a lesser extent *Consolidated Press* and *Hart*) demonstrates that this narrow approach will prevent a taxpayer from implementing a commercial transaction which is designed to take advantage of a specific tax preference.

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<sup>51</sup> 89 ATC 524,536

The New Zealand scheme and purpose approach provides an alternative approach to the application of Part 1VA ITAA 1936 which would allow taxpayers such as the Harts and companies like Consolidated Press to choose the lowest tax cost when deciding between alternative ways of implementing a genuine commercial transaction. That outcome would be in keeping with the EM, and at the same time leave the courts with an effective mechanism to apply Part 1VA ITAA 1936 to the traditional area of artificial blatant or contrived schemes.

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