
Policy Forum: New Zealand's General Anti-Avoidance Rule—A Triumph of Flexibility over Certainty

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CONTENTS

Introduction	147
A Brief History	148
The Current Law as Set Out in Ben Nevis	151
The Current Statute	152
The Approach of the Supreme Court	154
The Judicial Meaning of Tax Avoidance—The Parliamentary Contemplation Test	155
The Implications of a Broad GAAR and Robust Litigation	156
Flexibility	157
Certainty	159
Integrity of the System	161
Conclusion	163

INTRODUCTION

The oldest general anti-avoidance rule (GAAR) in the world is a somewhat crude instrument that has been honed to a very sharp edge by the New Zealand Supreme Court. The evolution of New Zealand's GAAR is classic evidence that, at least in New Zealand, such broadly worded anti-avoidance provisions are ultimately judge-made law. This conclusion is borne out—as this article seeks to demonstrate—by an analysis of the history of the NZ jurisprudence relating to GAAR.

The consistent problem with New Zealand's GAAR, and perhaps any statutory GAAR, is that it is drafted too broadly to provide certainty of outcomes to taxpayers,

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revenue officials, and the judiciary.¹ There are, of course, reasons why the NZ Parliament drafted the rule in this way. The purpose of New Zealand's GAAR is to anticipate and defeat the tax planning of clever people. The process of statutory interpretation of GAAR in New Zealand has been and is, fundamentally, one of judges trying to give meaning to a provision that on a literal interpretation has never made sense.²

That New Zealand's GAAR is predominantly judge-made law also explains, insofar as it is possible to do so, how the events of the last five years have quite significantly changed and developed the tax-avoidance landscape in New Zealand. This article attempts to explain the recent experience in light of the features of New Zealand's GAAR.

A BRIEF HISTORY

New Zealand has had a GAAR in its tax legislation since 1878,³ even before income tax was introduced.⁴ For much of its 136-year history, the provision remained virtually unchanged.⁵ In the 1960s, however, New Zealand's commissioner of inland revenue began to litigate using GAAR. Judicial criticism of deficiencies in the terms used in the statute was common. For instance in 1971, in one of the early NZ tax-avoidance cases to reach the Privy Council, *Mangin v. CIR*, Lord Wilberforce observed, "Originating in a desire to deal with the simple matter of incidence of land tax, [the

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- 1 This article focuses on the New Zealand GAAR and does not consider the definition of tax avoidance found in other, particularly Commonwealth, jurisdictions. New Zealand's GAAR is, generally speaking, much broader in its scope and definition than the equivalent provisions enacted by other jurisdictions such as Australia, Canada, and the United Kingdom. The current version of the New Zealand GAAR is contained in part B of the Income Tax Act 2007 (herein referred to as "the ITA").
 - 2 See the discussion on the statutory definition of "tax avoidance" below, under the heading "The Current Statute," and the conclusions of Michael Littlewood in his article "The Possibility of Amending New Zealand's Anti-Avoidance Rule" (2013) 25:3 *New Zealand Universities Law Review* 522, at 527.
 - 3 Section 62 of the Land Tax Act 1878 was an anti-avoidance provision designed to prevent landlords from transferring the burden of tax to their tenants.
 - 4 With the introduction of a New Zealand income tax, GAAR was enacted as section 40 of the Land and Income Tax Assessment Act 1891.
 - 5 Section 40 of the Land and Income Tax Assessment Act 1891 was replaced by section 82 of the Land and Income Tax Act 1900. Even as late as 1900, section 82 continued to have a carryover from section 62 of the Land Tax Act 1878 by continuing to refer to the avoidance of tax by arrangements and agreements made between landlords and tenants, between mortgagors and mortgagees, and between any other persons. It voided such "covenants or arrangements" that had the "purpose or effect of in any way directly or indirectly altering the incidence of any tax." Section 82 was re-enacted in identical terms in the Land and Income Tax Act 1908 and then again in the Income Tax Act 1916. After 1916, section 170 of the Land and Income Tax Act 1923 and section 108 of the Land and Income Tax Act 1954 were also based on this provision.

general anti-avoidance provision] has found itself confronted, with only minor changes of language, with all the sophistications of modern tax 'avoidance.'⁶

From 1916 to 1974, judges wrestled with the provision, which then read as follows:⁷

S 108. Every contract, agreement, or arrangement made or entered into, whether before or after commencement of this Act, shall be absolutely void in so far as, directly or indirectly, it has or purports to have the purpose or effect of in any way altering the incidence of income tax, or relieving any person from his liability to pay income tax.

Every *arrangement* that has the *purpose or effect of altering the incidence* of income tax includes virtually every transaction where the hypothetical maximum amount of tax is not paid. This meant that, in theory, virtually every transaction was capable of being voided by section 108. Judges (being, on the whole, rational and intelligent) decided that the words could not mean what they said. The response was to import some limitations into section 108, which were frequently referred to as judicial glosses. These included, inter alia, the following propositions:

- Tax avoidance should be established by reference only to objective factors (overt acts and outcomes), and not subjective factors (motives and intentions).
- Transactions capable of explanation by reference to ordinary business or family dealings would not come within GAAR.⁸

In some circumstances, though, even family or business dealings would be caught by section 108 if the purpose or effect of tax relief was pursued as a goal in itself, as opposed to arising as a natural consequence of some other business or family purpose.⁹ It was unclear exactly what family or business dealing would be immune to a GAAR attack. The statutory provision itself was criticized because “[i]t cannot be given a

6 *Mangin v. Commissioner of Inland Revenue*, [1971] NZLR 591, at paragraph 601. The first NZ case considered by the Privy Council was actually much earlier and concerned the anti-avoidance provisions relating to death duty in the decision *Minister of Stamps v. Townend*, [1909] AC 633 (PC).

7 The provision relevant in the 1960s was section 108 of the Land and Income Tax Act 1954, which remained unchanged from 1916.

8 These propositions were espoused by New Zealand judges as a consequence of the Privy Council's decision on the equivalent Australian GAAR provision in *Newton v. Commissioner of Taxation of the Commonwealth of Australia*, [1958] AC 450 (PC). In that case, the Privy Council proposed that a purpose of tax avoidance could be established by predication—that is, the motives of the taxpayer were irrelevant but the statutory purpose of tax avoidance was to be discerned by the taxpayer's overt acts of implementation—and that such a tax-avoidance purpose could not be established if the actions of the taxpayer were referable to ordinary family or business dealing. *Ibid.*, at 454–56. As a result of the second proposition, taxpayers had an automatic defence against the application of GAAR if they could establish that the transaction in question was ascribable to an ordinary family or business dealing.

9 *Elmiger v. Commissioner of Inland Revenue*, [1966] NZLR 683, at paragraph 694 (per Woodhouse J).

literal application, that would . . . result in the avoidance of transactions which were obviously not aimed at by the section.”¹⁰

The resulting confusion necessitated changes to the legislation, which were made in 1974.¹¹ These changes made it clear that, first, a “tax avoidance arrangement” included an arrangement one of the purposes of which was tax avoidance (that is, tax avoidance was not a “merely incidental” purpose); and second, a “tax avoidance arrangement” could arise even where the purposes or effects of the arrangement were referable to ordinary business or family dealings.¹² However, the amended legislation did not explain the relationship between substantive black-letter tax provisions, particularly those that expressly permitted tax concessions, and the general anti-avoidance provision.

This issue of the relationship between specific provisions and GAAR arose in a 1986 decision of the Court of Appeal. In *Challenge Corporation*,¹³ the majority of the court decided that a tax-paying group could purchase an unconnected company that had no assets other than a carryforward loss, and could offset that loss against other companies’ group profits, unaffected by the application of GAAR.¹⁴ The loss could be grouped with the profits of the other companies using a specific provision in the taxation Act. Richardson J analyzed the relationship between the specific loss offset provisions relating to group companies and GAAR, and developed what is often described as “the scheme and purpose approach” to tax-avoidance analysis.¹⁵ He concluded that the taxpayer’s transactions were simply tax-authorized elections and that Parliament could not have intended that GAAR would apply to deprive taxpayers of specific options available under the grouping rules.¹⁶ On appeal, the Privy Council

10 *Commissioner of Inland Revenue v. Gerard*, [1974] 2 NZLR 279, at paragraph 280 (CA) (per McCarthy P). As a result of this and other judicial criticism, quite significant reforms occurred in 1974 (see *infra* note 11 and the related text).

11 Land and Income Tax Amendment Act (No 2), section 9.

12 For a fuller description, see the decision of the New Zealand Supreme Court in *Ben Nevis Forestry v. CIR*, [2008] NZSC 15. *Ben Nevis* is discussed in detail below.

13 *Challenge Corporation Limited v. Commissioner of Inland Revenue*, [1986] 2 NZLR 513 (CA).

14 *Ibid.*, at paragraph 545. Richardson J concluded that the GAAR legislation had not defined its relationship with specific deduction provisions and that it was a task of the court to decide what was proper and improper tax avoidance.

15 *Ibid.*, at paragraph 549, where Richardson J held, “For the enquiry is as to whether there is room in the *statutory scheme* for the application of s 99 in the particular case. If not, that is because the state of affairs achieved in compliance with the particular provision relied on by the taxpayer is not tax avoidance in the statutory sense. Reading s 99 in this way is to give it its *true purpose and effect* in the *statutory scheme* and so allow it to serve the purposes of the Act itself. It is not the function of s 99 to defeat other provisions of the Act or to achieve a result which is inconsistent with them [emphasis added].” Section 99 is the predecessor provision to ITA section BG 1.

16 *Ibid.* The other majority judge, Cooke J, agreed with this decision but on different grounds, holding that a specific anti-avoidance provision displaced the application of GAAR in this situation.

reversed the decision and applied GAAR, adopting a broader approach that considered the economic reality of the transaction and deciding against a taxpayer who sought to obtain a tax advantage without suffering an economic cost.¹⁷

Subsequent decisions in New Zealand broadly followed the scheme and purpose approach.¹⁸ This was subject to consideration of whether, on the true construction and application of the specific provision, Parliament could have intended to give the particular tax benefit claimed.

This brings us to more recent events and the decisions of the New Zealand Supreme Court in late 2008. The court, concerned with “continuing uncertainty about the interrelationship of the general anti-avoidance provision with specific provisions,” set out to “settle the approach which should be applied in New Zealand.”¹⁹

THE CURRENT LAW AS SET OUT IN BEN NEVIS

Before I discuss the crucial Supreme Court decision in *Ben Nevis*, a brief description of the background facts may be helpful.²⁰

The tax-avoidance issue in *Ben Nevis* arose from “the Trinity scheme,” New Zealand’s largest tax-planning scheme to date, involving a potential \$3 billion of deductions. The underlying investment was the development of a Douglas fir forest, which would be ready for harvest by 2048. Essentially, the scheme was designed to work as follows:

- The taxpayers undertook to pay an inflated licensing fee in 2047 for use of the forestry land.
- The taxpayers also entered into a captive insurance arrangement to ensure that, if the net proceeds from the sale of the harvested trees were not sufficient to fund the payment of the licensing premium in 2048, the investors could still meet the payment.
- The bulk of the licence and insurance premium payment obligations were satisfied by the issuance of promissory notes by the taxpayers, so that, for an annual cash outlay of \$50 per hectare, each taxpayer could obtain annual tax deductions of approximately \$41,000 per hectare.

The High Court and the Court of Appeal both found in favour of the commissioner of inland revenue, agreeing that the scheme was a tax-avoidance arrangement.

17 [1987] AC 155, at paragraphs 36 and 37 (PC).

18 See *Commissioner of Inland Revenue v. BNZ Investments Ltd.*, [2002] 1 NZLR 450 (CA), and *Peterson v. Commissioner of Inland Revenue*, [2006] 3 NZLR 433 (PC). An outlier decision is that of the Privy Council in *Commissioner of Inland Revenue v. Auckland Harbour Board*, [2001] 3 NZLR 17,008, where significantly less emphasis was placed on the application of GAAR.

19 *Ben Nevis*, supra note 12, at paragraph 100.

20 The facts of the case are summarized in Craig Elliffe and Mark Keating, “Tax Avoidance—Still Waiting for Godot?” (2009) 23:3 *New Zealand Universities Law Review* 368-92, at 370.

The taxpayers appealed to the Supreme Court, which also agreed that the arrangement crossed the line of acceptable tax planning.²¹ Although the decision concerned the Income Tax Act 1994, there is no material difference in the current 2007 statute (the ITA).²²

The Current Statute

Part B of the ITA provides, under the heading “Overriding effect of certain matters,” that “the Commissioner may counteract a tax advantage from a tax avoidance arrangement.”²³ Subpart BG deals with tax avoidance and simply states that “a tax avoidance arrangement is void as against the Commissioner for income tax purposes.”²⁴

Therefore, a key definition is the meaning of “tax avoidance arrangement.”²⁵ That definition reads as follows:

- ... 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.²⁶

It is unusual (though quite possible) to have an arrangement that has tax avoidance as its sole purpose or effect.²⁷ Much more common is a commercial transaction that has a tax-avoidance purpose or effect as one of its purposes or effects.²⁸ What, then, is the meaning of “tax avoidance”? The ITA defines “tax avoidance” to include

- (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:

21 For a full analysis of the Supreme Court’s reasoning, see Elliffe and Keating, *ibid.*

22 *Supra* note 1.

23 ITA section BB 3 (1).

24 ITA section BG 1 (1).

25 In my view, a much less important definition is that of an “arrangement,” which is found in ITA section YA 1 and is of such a broad and all-encompassing nature that it is difficult to think of any form of transaction, plan, or loose understanding that would fall outside its scope.

26 ITA section YA 1.

27 Oddly enough, some transactions that have tax avoidance as a sole purpose—for example, an investment in a portfolio investment entity deposit account—have been held by the Supreme Court not to be a tax-avoidance arrangement. The Supreme Court in *Penny and Hooper v. Commissioner of Inland Revenue*, [2011] NZSC 95, at paragraph 49, suggested that sometimes Parliament contemplates that a tax provision can be used deliberately to obtain a tax advantage.

28 The statutory definition of “tax avoidance arrangement” has the effect of narrowing the statutory definition of “tax avoidance,” in particular by introducing the concept of taking outside that definition those transactions that only have a “merely incidental” tax-avoidance purpose.

(c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax.²⁹

The statutory definition of “tax avoidance” is problematic for the following reasons:

- First, it refers to “altering the incidence of any income tax.” This is the same complication referred to above in discussing section 108 of the 1954 Act. Any modification to a transaction that results in a tax saving from a hypothetical maximum can potentially cause the transaction to be caught as tax avoidance, no matter how commercially valid the transaction may be. For example, take a sole trader who pays tax at 33 percent³⁰ and decides to incorporate his or her business. Read literally, GAAR would apply to the commercial use of a corporate entity in New Zealand, which pays tax at 28 percent,³¹ since the process of transferring the business from an individual to a lower-rate taxpayer wholly owned by the individual (or his or her associates) would always be an example of altering the incidence of tax.³² That proposition is clearly untenable, although there will be some circumstances where the transaction or structure adopted would be captured by GAAR.³³
- Second, characterizing as tax avoidance a transaction that has the effect of relieving a person from potential or prospective liability to future income tax produces even more bizarre outcomes. Such a broad application would catch, for instance, the sale of income-producing assets, the decision to undertake various investments³⁴ (in terms of both income-producing yield versus capital growth and the location of the investments), employment and career decisions, and decisions as to residence. This must be why Michael Littlewood suggests

29 ITA section YA 1.

30 The current maximum individual rate for NZ taxpayers.

31 The corporate rate of tax.

32 A consequence of such an approach is that, for tax reasons, business people who began as sole traders would have to remain so for the entire duration of the business, irrespective of creditor-protection concerns or commercial convention and desirability.

33 The incorporation of a sole trader offends against the definition of tax avoidance because in such cases, first, one or more taxpayers alter the incidence of their tax liabilities, and second, the change in entity results in a change of tax incidence. This is not to say that in some circumstances the decision to incorporate a business is not tax avoidance. The payment of a non-market salary by orthopaedic surgeons after they had transferred their business to a corporate entity constituted tax avoidance in the Supreme Court decision in *Penny and Hooper*, supra note 27. The key issue in that case, however, was not the use of a corporate structure but rather the non-market salary paid to the orthopaedic surgeon.

34 For example, an avoidance transaction could arise if a taxpayer withdrew money from a term deposit yielding 8 percent to make a residential property investment with a negative income return and an expected tax-free capital gain, or, alternatively, to make an overseas share investment.

that “to define tax avoidance as meaning *any* act that reduces a person’s liability to tax would produce absurd results.”³⁵

The Approach of the Supreme Court

Given the above comments about both the historical and the current statute, it is no surprise that the Supreme Court in *Ben Nevis* spent little time in trying to analyze the definitions of “tax avoidance” and “tax avoidance arrangement.” The court reflected that, in its view, Parliament had deliberately chosen to leave to the judiciary the job of working out the kind of arrangements that are caught by GAAR.³⁶ This feature of the NZ GAAR jurisprudence has been noted by the inland revenue commissioner in her recent interpretation statement:

The Commissioner’s view is that Parliament’s purpose in enacting the definition of “tax avoidance” was to confirm or clarify that certain circumstances will constitute tax avoidance, rather than to provide a comprehensive definition of what constitutes tax avoidance. This is supported by the fact that, in establishing whether there is tax avoidance, the courts (including the Supreme Court in *Ben Nevis*) have typically come to a conclusion without embarking on any detailed analysis of the statutory definition of “tax avoidance” and, at times, have not referred to the definition at all.³⁷

In *Ben Nevis*, the Supreme Court referred to the definition of “tax avoidance” but performed no analysis of the statutory definition.³⁸ Instead, the court did the only sensible thing it could do, given the breadth of the definition, and set out to give its own meaning to the provision. It did so by creating the parliamentary contemplation test.

35 Littlewood, *supra* note 2, at 527.

36 *Ben Nevis*, *supra* note 12, at paragraph 101.

37 New Zealand, Inland Revenue Department, *Interpretation Statement*, “Tax Avoidance and the Interpretation of Sections BG 1 and GA 1 of the Income Tax Act 2007,” June 13, 2013, at paragraph 148.

38 This approach of not undertaking a detailed analysis of the GAAR statute is consistent with decisions of the NZ courts both pre- and post-*Ben Nevis*. This is noted by the commissioner in her interpretation statement, *supra* note 37, at paragraphs 154 and 157. Pre-*Ben Nevis*, neither the Privy Council in *Miller v. Commissioner of Inland Revenue*, [2001] 3 NZLR 316, and *Peterson*, *supra* note 18, nor the New Zealand Court of Appeal in *Dandelion Investments Limited v. Commissioner of Inland Revenue*, [2003] 1 NZLR 600, did so. Post-*Ben Nevis*, the statutory definition is not regarded as being important in the Supreme Court decision in *Penny and Hooper*, *supra* note 27, and also does not feature in the High Court decisions in *Westpac Banking Corp. v. Commissioner of Inland Revenue* (2009), 24 NZTC 23,834 (HC); *BNZ Investments*, *supra* note 18; and *White v. Commissioner of Inland Revenue* (2010), 24 NZTC 24,600 (HC).

The Judicial Meaning of Tax Avoidance— The Parliamentary Contemplation Test

The parliamentary contemplation test involves a two-step analysis, which the Supreme Court described at some length and summarized as follows:

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.³⁹

The first step in the analysis is to identify Parliament's purpose in enacting the relevant provision (or possibly a combination of provisions). In the Supreme Court's words, "[t]he taxpayer must satisfy the Court that the use made of the specific provision is within its intended scope."⁴⁰ The inquiry is therefore focused on what outcome Parliament intended for the provision or provisions.⁴¹ This may be ascertained through the process of statutory interpretation, necessarily considering the meaning and context of the provision(s), together with the legislative history. But reference may also be had, of course, to case law, and perhaps to relevant extrinsic material, particularly to confirm a decision based on the analysis of the relevant provisions.⁴²

The second step requires an analysis of the commercial reality and economic effects of the arrangement. This involves an examination of "the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole."⁴³ It seems clear from the decision in *Ben Nevis* that this test empowers the commissioner and the courts to look behind the transaction in order to understand what is truly going on. For instance, is the expenditure truly being borne (that is, is the economic burden really sustained by the payer)? Or is the expectation that the resultant loan will not be repaid; or, if it is repaid, does this occur out of self-generated and inflated profits derived from a circular transaction?

In order to determine the commercial reality and economic effects of an arrangement, the Supreme Court highlighted a number of "relevant factors" that could be considered.⁴⁴ These include

39 *Ben Nevis*, supra note 12, at paragraph 109.

40 *Ibid.*, at paragraph 107.

41 *Ibid.*: "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 [emphasis added]."

42 *Interpretation Statement*, supra note 37, at paragraphs 226-234.

43 *Ben Nevis*, supra note 12, at paragraph 107.

44 *Ibid.*, at paragraph 108.

[t]he manner in which the arrangement is carried out. . . . [T]he role of all relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of documents and transactions. . . . [T]he duration of the arrangement and the nature and extent of the financial consequences [and the structure or nature] of an arrangement [if it is carried out] in an artificial or contrived way.⁴⁵

The commissioner makes the point in her interpretation statement that the second step of ascertaining commercial reality and economic consequences may inform the analyzer about Parliament's purpose in the context of the particular arrangement.⁴⁶ Consequently, steps one and two may be an iterative process.

Finally, if it is determined, as a result of the parliamentary contemplation test, that the arrangement has tax avoidance as a purpose or effect, it is then necessary to examine whether that tax-avoidance purpose is merely incidental. The Supreme Court in *Ben Nevis* was very brief on the role of the "merely incidental" test, noting that

it will rarely be the case that the use of a specific provision in a manner which is outside parliamentary contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental.⁴⁷

The commissioner, relying on dicta from the Supreme Court decision in *Penny and Hooper*,⁴⁸ will apply the merely incidental test by examining non-tax-avoidance purposes, in order to determine whether the tax-avoidance purpose or effect follows from, or is concomitantly linked to, without contrivance, those other commercial and private purposes or effects.⁴⁹

THE IMPLICATIONS OF A BROAD GAAR AND ROBUST LITIGATION

There is no criticism of the judiciary in all of this, because they have been doing the best that they can to discern where to draw the line on impermissible tax avoidance, given the breadth of the meaning of tax avoidance in the statute. They have been doing an exercise in statutory interpretation that, from necessity, has placed a heavy emphasis on the word "interpretation" and precious little on the word "statutory." "What Parliament contemplates" is a judge-made test simply because the Supreme Court had to devise a mechanism to guide taxpayers, tax administrators, and the lower

45 Ibid. That this is not an exhaustive list is suggested by the court's comment that "the general anti-avoidance provision does not confine the Court as to the matters which may be taken into account when considering whether a tax avoidance arrangement exists."

46 *Interpretation Statement*, supra note 37, at paragraph 386.

47 *Ben Nevis*, supra note 12, at paragraph 114.

48 *Penny and Hooper*, supra note 27, at paragraph 34.

49 *Interpretation Statement*, supra note 37, at paragraphs 431-438.

courts; the court could not rely on guidance from the statute itself; and the court wanted to resolve 50 years of confusing case law.

Parliament wants specific tax provisions to work, but it does not want them to be abused, either in isolation or in combination. To achieve the desired balance, the relation between GAAR and specific provisions is resolved by interpreting them as provisions that are “meant to work in tandem.”⁵⁰ Under a purposive interpretation, given that GAAR is the principal vehicle to address tax avoidance, Parliament applies GAAR in circumstances where a specific provision is being used in a way that Parliament would not have contemplated.⁵¹ This tandem approach, together with the second step of the parliamentary contemplation test, gives the court greater scope to examine the economic substance of what has really occurred in a particular transaction.

The flaw in the *Ben Nevis* decision, and in most other decisions relating to GAAR, is the absence of an analysis of the statute itself, for the reasons previously discussed. Perhaps recent judges should have been more critical and strident in expressing dissatisfaction with the provision.⁵² That said, the courts seem to be doing a much more complete job than Parliament, in accordance with Parliament's general directives to them.

Flexibility

The progression from the predication test to the scheme and purpose analysis, and now to parliamentary contemplation, indicates significant flexibility in the judicial approach. Several developments in the *Ben Nevis* case illustrate this point.

My view, which is shared by others,⁵³ is that, with the decision in *Ben Nevis*, the Supreme Court has successfully refined and developed GAAR jurisprudence: first, by more clearly defining the relationship between GAAR and the interpretation of specific tax provisions (the so-called tandem approach); and second, by proposing an analysis that involves an inquiry into the commercial and economic reality of transactions and the use of specific tax provisions seen through the lens of how Parliament intended the provisions to be used (the second step of the parliamentary contemplation test).

The tandem approach to interpreting the specific provisions and GAAR represents a subtle change in emphasis from the previous scheme and purpose test. This is the

50 *Ben Nevis*, supra note 12, at paragraph 103.

51 *Ibid.*, at paragraph 104.

52 See Lord Wilberforce's criticism of the GAAR provision in *Mangin*, supra note 6.

53 See, for example, David Dunbar, “Tax Avoidance: The Court of Appeal Judgment in Penny and Hooper, the Application of the Parliamentary Contemplation Test, and the Demise of Scheme and Purpose” (2011) 17:4 *New Zealand Journal of Taxation Law and Policy* 395-417; and Craig Elliffe and Jessica M. Cameron, “The Test for Tax Avoidance in New Zealand: A Judicial Sea Change” (2010) 16 *New Zealand Business Law Quarterly* 440-60.

view of Supreme Court Justice Susan Glazebrook, speaking extrajudicially. In a recent conference paper,⁵⁴ she noted with interest that in the Court of Appeal decision in *Challenge*,⁵⁵ the majority (who decided in favour of the taxpayer) had considered the role of the specific provisions *prior to* considering GAAR.⁵⁶ This approach could be distinguished from that of the minority, who considered the anti-avoidance provisions first.⁵⁷ Her Honour speculated that the tandem approach may change the outcome in the decision-making process.

Justice Glazebrook also considered that a greater emphasis on the commercial and economic consequences of the wider transaction, which is the second step of the parliamentary contemplation test, may also, arguably, contribute to this change in emphasis.⁵⁸ She highlighted consideration of the existence of non-market transactions in recent decisions such as *Glenbarrow*⁵⁹ and *Penny and Hooper*,⁶⁰ representing a change from the approach taken by the court in *Europa*⁶¹ and *Peterson*.⁶² (In these earlier Privy Council cases, a majority of the panel had accepted the deductibility of expenditures on the basis of the legal instruments entered into, without undertaking a significant inquiry into the underlying economics of the transaction.)

This ability to formulate new approaches, whether they are described as subtle or as a sea change,⁶³ is nonetheless a change that authorizes judges to conduct a closer examination of the commercial and economic consequences of transactions. This is clearly a desirable development in tax-avoidance jurisprudence from a broader societal perspective.⁶⁴

54 Susan Glazebrook, "Statutory Interpretation, Tax Avoidance and the Supreme Court: Reconciling the Specific and the General," paper prepared for the New Zealand Institute of Chartered Accountants Tax Conference, held in Auckland from November 7-9, 2013.

55 *Challenge*, supra note 13.

56 *Ibid.* Richardson J and Cooke J started with the loss offset provision prior to examining the role of GAAR.

57 *Ibid.* In the minority decision, Woodhouse P started with the anti-avoidance provision and held that GAAR did apply.

58 Glazebrook, supra note 54. Justice Glazebrook noted that this wider view, considering the economic effects of transactions, was arguably similar to the approach of the Privy Council in *Challenge*, supra note 17.

59 *Glenbarrow Holdings Ltd. v. Commissioner of Inland Revenue* (2009), 24 NZTC 23,236 (SC).

60 *Penny and Hooper*, supra note 27.

61 *Europa Oil (NZ) Ltd. v. Commissioner of Inland Revenue*, [1976] 1 NZLR 546.

62 *Peterson*, supra note 18.

63 Another alternative view is that the *Ben Nevis* decision marks a return to jurisprudential tax-avoidance orthodoxy after the approach of the Privy Council in *Peterson*, and in *Auckland Harbour Board*, supra note 18, which might be viewed as a high watermark of form over substance.

64 Provided that one thinks that the prevention of tax avoidance should be facilitated.

Certainty

The disadvantage of flexibility is lack of certainty, and lack of certainty is undesirable for commerce. The position of the Supreme Court on this point, however, is clear: “The courts should not strive to create greater certainty than Parliament has chosen to provide.”⁶⁵

Recent cases in New Zealand have created quite a furor because the line between legitimate tax planning and tax avoidance was either mistaken by taxpayers and their advisers or redefined by the first GAAR cases heard in the New Zealand Supreme Court.⁶⁶ It is contended that the approach taken by the Supreme Court, and its subsequent application in the High Court⁶⁷ and the Court of Appeal,⁶⁸ surprised those closely involved in taxation.⁶⁹

In support of this contention, one can point to the reaction of taxpayers and their advisers to the *Ben Nevis* decision. Three influential taxation groups, concerned about developments in anti-avoidance, prepared a report on improving the operation of New Zealand’s tax-avoidance laws.⁷⁰ This report made suggestions for legislative reform and other changes to the tax administration process with respect to the operation of GAAR. The report, written in 2011, stated:

Until three or four years ago, it was generally understood that commonplace arrangements which resulted in tax savings should not be subject to the GAAR. The basis for this understanding is best captured by the following passage in the Australian Tax Office statement^[71] summarising the principles of Australia’s GAAR: . . .

It is reasonable to assume that the tax opportunities of straight-forward dealing have been considered by those who design tax laws, and having been considered, if not then prevented, have in effect been implicitly sanctioned. . . .

Most tax specialists would agree that the statement no longer reflects Inland Revenue’s practice in New Zealand. Nor does it reflect the approach being taken by at least some High Court and appellate court Judges.⁷²

65 *Ben Nevis*, supra note 12, at paragraph 112.

66 *Ben Nevis*, *ibid.*, and *Glenbarrow Holdings*, supra note 59.

67 In particular, the structured finance cases heard in the Auckland and Wellington High Courts in *Westpac* and *BNZ Investments*, supra note 38.

68 *Alesco New Zealand Limited v. CIR*, [2013] NZCA 40.

69 Rather than the outcome of the cases themselves, both of which seem to involve rather egregious and heavily tax-influenced transactions to which GAAR should apply.

70 Taxation Committee of the New Zealand Law Society, Corporate Taxpayers Group, and Taxation Committee of the New Zealand Institute of Chartered Accountants, “Report: Improving the Operation of New Zealand’s Tax Avoidance Laws” (2011) 17:4 *New Zealand Journal of Taxation Law and Policy* 351-93.

71 Australian Taxation Office, *Practice Statement Law Administration* PS LA 2005/24, “Application of General Anti-Avoidance Rules,” December 13, 2005, at paragraph 2.8.

72 Supra note 70, at 354-55.

It was not only tax advisers and taxpayers who were caught like possums in the headlights. According to the report, different divisions of Inland Revenue took different views on the application of GAAR. Taxpayers who had received a favourable ruling on one particular transaction could not rely on it in respect of other similar or virtually identical transactions where different Inland Revenue personnel were assessing the tax outcome.⁷³

Major NZ corporate taxpayers who had entered into very significant transactions were suddenly on the front page of the business papers, being accused of tax avoidance. These corporations were advised by the best tax lawyers and accountants, yet the tax position they had taken ultimately seemed untenable in light of the new case law. As a result, New Zealand saw a high level of litigation involving complex billion-dollar transactions in the so-called structured finance cases.⁷⁴ Two such cases, *Westpac* and *BNZ Investments*,⁷⁵ were decided in favour of the commissioner at the High Court level and subsequently settled by the parties.

The change in approach affected smaller taxpayers as well as multinationals. For example, the *Penny and Hooper* case,⁷⁶ involving the diversion of personal services income using interposed entities to derive income, applied to small and medium-sized businesses but affected a significantly larger group of taxpayers than did the structured finance cases.

Lack of certainty for taxpayers continues as more litigation regarding various forms of hybrid instruments used in cross-border funding is currently being progressed. In early 2014, the Supreme Court will hear an appeal of the *Alesco* case⁷⁷ relating to the use of optional convertible notes (OCNs). In that case, the Court of Appeal decided that the transactions constituted a tax-avoidance arrangement.

A number of commentators have expressed concern about the impact on business caused by lack of certainty. For example, Kirsty Keating, a New Zealand-based tax partner with Ernst & Young has pointed out:

While uncertainty is inherent in the application of general anti-avoidance provisions, the current lack of guidance is causing real problems both to the taxpayers and potentially for the New Zealand economy as a whole. A number of large taxpayers are beginning

73 *Westpac*, supra note 38. The court stated, at paragraph 29, “On the other hand, there plainly was a difference in approach between the two business units [within Inland Revenue]. At a broad level, Corporate staff were generally far more sceptical of the repo deals than Rulings had been in relation to the First Data transaction. As well, Corporate took a more bullish (or perhaps aggressive) approach to the application (and scope) of s BG 1.”

74 The tax position taken in the structured finance cases and the litigation commenced prior to the decision in *Ben Nevis*, supra note 12.

75 *Westpac*, supra note 38, and *BNZ Investments Limited v. CIR* (2009), 24 NZTC 23, 582.

76 *Penny and Hooper*, supra note 27.

77 *Alesco*, supra note 68.

to ask whether it is worth remaining in New Zealand given the tax uncertainty they face when planning investment in structural choices in this country.⁷⁸

Clearly, if multinational businesses rely on unintended tax advantages relating to tax avoidance to justify investment in a country, such investment may not be desirable. But there is a valid concern if the tax system is seen as an impediment to mainstream (rather than tax-driven) commercial transactions and foreign investment. This seems to be a widely held view in the private sector, but it is very difficult to validate except by anecdotal experience.

Integrity of the System

New Zealand is extremely lucky to have, on the whole, both a clear-headed judiciary and a responsible tax administration, because a relatively unfettered discretion in the use of GAAR can make the conduct of commerce difficult. Less scrupulous regimes would make the existence of such a broad GAAR impossible because of the risk that the administration might abuse its power. There is still a concern in New Zealand that GAAR may be used to make retrospective changes to deficient legislation.

Inland Revenue released its 133-page interpretation statement in June 2013.⁷⁹ The document is a comprehensive and constructive analysis of considerable merit. The commissioner provides assurance that she exercises great care in the application of GAAR, noting that Inland Revenue has a centralized system that carefully controls and authorizes its use.

One point also requires further clarification in the courts, because there is inconsistency. It relates to the use of objective and subjective evidence. The Supreme Court, seeking a principled approach that would give greater certainty, reinforced that an NZ court should focus “objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisers have set up.”⁸⁰ The court has thus clarified that one aspect of Lord Denning’s famous predication test in *Newton*⁸¹ is alive and well: In determining the purpose or effect of an arrangement, what is assessed as a matter of evidence is the actions of the taxpayer, rather than subjective comments.⁸²

78 Kirsty Keating, “Reform of the General Anti-Avoidance Provision—The Iron Is Hot” (December 2011) no. 6 *New Zealand Tax Planning Report* (CCH New Zealand).

79 *Interpretation Statement*, supra note 37.

80 *Ibid.*, at 102. Despite the clear authority that the purpose or effect of the arrangement should be determined objectively, in *Alesco*, supra note 68, the commissioner advanced documents generated by the taxpayer and its tax advisers that refer to the tax savings available under the OCN arrangement as proof of its tax-avoidance purpose.

81 *Newton*, supra note 8, at 454-56.

82 This is in contrast to the other aspect of Lord Denning’s test, which exonerated family and business dealings from the application of GAAR and which the 1974 statute repealed. *Ibid.*

This component of the predication test is not to be confused with the second step of the parliamentary contemplation test. The latter seems to require an examination of the arrangement in a commercial and realistic way, and may involve looking at a taxpayer's—or an adviser's—subjective comments. If the court wishes to make selective use of subjective or objective evidence to achieve different aims, this should be made clear.

A real problem exists in respect of GAAR and its administration. Since 1996, New Zealand has operated a civil penalties regime (known as “shortfall penalties”) to deter and punish taxpayers for their non-compliance.⁸³ Taxpayers who engage in tax avoidance may be liable for the imposition of the shortfall penalty for taking an “abusive tax position,”⁸⁴ calculated at 100 percent of the tax underpayment resulting from their avoidance.⁸⁵ The penalty may be imposed when the taxpayer has both taken an unacceptable tax position and done so with a dominant purpose of avoiding tax. However, the assessment of that penalty on tax avoiders is far from certain.⁸⁶

The first requirement before the penalty can be imposed is that the taxpayer's argument fails to meet the standard of “about as likely as not to be correct.”⁸⁷ This has been interpreted to mean that the taxpayer needs to have a reasonable and credible argument to support its position, even if that position is not necessarily correct.⁸⁸ Thus, the court may find that a taxpayer has committed tax avoidance but nevertheless still had a reasonable argument, and therefore the shortfall penalty will not apply. This approach ensures that the penalty applies to only the most egregious instances of tax avoidance—avoidance that is abusive, and as such is deserving of a significant penalty.

Significantly, the legal merits of the arrangement must be determined at the time that the taxpayer's position is taken (that is, when the return is filed), not when the court comes to consider that position years later.⁸⁹ So the question must be whether the taxpayer's position, at the time taken, was one that was obviously incorrect, rather than one that subsequently turns out to be wrong.

If the hypothesis in this article is correct, and the test of tax avoidance has changed over time, then careful attention needs to be paid to the applicable case law

83 Tax Administration Act 1994, section 139.

84 *Ibid.*, section 141D.

85 See *Ben Nevis*, supra note 12, particularly the discussion at paragraphs 177-178 regarding the rationale for imposing such a penalty for tax avoidance.

86 The penalty was not imposed in a number of tax-avoidance cases, including *Glenbarrow*, supra note 59, and *Penny and Hooper*, supra note 27.

87 Tax Administration Act 1994, section 141B.

88 *Ben Nevis*, supra note 12, at paragraph 184: “On its terms this standard does not require that the appellants' tax position had a 50 per cent prospect of success but, subject to that qualification, the merits of the arguments supporting the taxpayer's interpretation must be substantial.”

89 Tax Administration Act 1994, section 141B (6).

at the time the tax position was taken. Recent decisions, such as the *Alesco* decision in the Court of Appeal, have been criticized because penalties have been imposed without sufficient analysis of the state of the law at the time the transaction was entered into.⁹⁰

CONCLUSION

The last five years, post-*Ben Nevis*, have seen significant changes in the operation of New Zealand's GAAR. The uncertainty and disruption caused by litigation in this recent period will, in time, be forgotten.

Few would argue that GAAR, as it is currently being applied, is not effective in preventing tax avoidance. It is even effective in proscribing interest expense incurred in cross-border hybrid instrument funding.⁹¹ The underlying reason for this is, paradoxically, the lack of precision in the definition of "tax avoidance" and the consequential need for the judiciary in New Zealand to formulate and develop principles and more detailed tests to counter tax avoidance. Perversely, the breadth of New Zealand's GAAR is a design feature of significant value.

In *Glenbarrow*, the Supreme Court reflected that when Parliament enacts a measure such as a *general* anti-avoidance provision, the benefit of the taxing statute's ability to anticipate and deal with tax avoidance is traded off against certainty:

There will also inevitably be uncertainty whenever a taxing statute contains a general anti-avoidance provision intended to deal with and counteract such artificially favourable transactions. It is simply not possible to meet the objectives of the general anti-avoidance provision by the use, for example, of precise definitions, as may be able to be done where an anti-avoidance provision is directed at a specified type of transaction.⁹²

The significant advantage of judicial flexibility found in the NZ system does come at a cost. It remains to be seen whether New Zealand's approach—one that effectively asks the courts to periodically draw the line in fact-specific situations—is superior to that of other jurisdictions that attempt a more detailed statutory definition.

Meanwhile, the NZ statute is likely to remain unchanged since there is no appetite to amend it. Maybe that is a good thing. This is not because uncertainty is desirable but because the New Zealand Supreme Court has been able to successfully

90 Craig Elliffe and Mark Keating, "Alesco New Zealand Limited v CIR: Concerns over the Broad Discretion in the Application of the New Zealand GAAR" [2013] no. 3 *British Tax Review* 275-87.

91 The decision in *Alesco*, supra note 68, proceeds on appeal to the Supreme Court early in 2014. New Zealand's GAAR could therefore be seen as an important mechanism to prevent base erosion and profit shifting, in the sense of addressing several of the problem areas identified by the OECD in its 15-point action plan: Organisation for Economic Co-operation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013).

92 *Glenbarrow Holdings*, supra note 59, at paragraph 48.

develop key tests and provide guidance. On the basis of the 136-year history of New Zealand's GAAR, one could expect the judiciary to further refine the parliamentary contemplation test into yet another approach.⁹³ The overall experience with GAAR in New Zealand suggests that flexibility is viewed as more desirable than certainty—a perspective that is obviously better for tax administrators than for tax advisers and their clients.

93 In the way that the common law develops as different judges respond to different fact situations.