

**Judicial Techniques for Controlling  
the New Zealand General Anti-Avoidance Rule:  
A Case of Old Wine in New Bottles,  
from Challenge Corporation to Peterson**

**WORKING PAPER SERIES  
Working Paper no. 38  
2005**

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General Anti-Avoidance Rule: A Case of Old Wine in New Bottles,  
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## **1. INTRODUCTION**

The judgment of the Privy Council in the recent Peterson case highlights the difficulty of deciding whether a general anti-avoidance rule should apply to set aside for tax purposes a passive investment structure which sought to take advantage of a number of unrelated provisions in the Income Tax Act 2004 (ITA). The taxpayer invested in a film known as *Lie of the Land* which was a commercial failure. The film was never released yet the tax system not only underwrote the taxpayer's investment, but it also enabled him to make a cash profit from what could be fairly described as a financial disaster. The financial success or failure of the investment (post tax) turned on whether the courts were prepared to allow the Commissioner of Inland Revenue (CIR) to apply the general anti avoidance rule to cancel the cash profit made by the taxpayer. That case is the motivation for this working paper.

During the last 30 years the ITA has been extensively amended as part of a major overhaul of the income tax system. However there have been no changes to section BG 1 since the 1974 amendments. This working paper examines the NZ judicial approach to the interpretation of section BG 1 to ascertain how of the judiciary have applied this provision to tax planning arrangements which reflect the extensive amendments enacted during the last 30 years. There is a line of cases starting with Challenge and ending with the recent decision in Peterson which provides a platform to examine the broad question whether it is possible for a general anti avoidance rule to be consistently applied by the New Zealand courts to sophisticated schemes which were deliberately designed to enable the taxpayer to obtain tax advantages which in all probability were not contemplated by the legislature at the time the relevant tax rules were enacted?

A second working paper will consider the interpretive approach taken by the Courts in Canadian and Australia to similar anti-avoidance provisions to ascertain whether there are any developments in those two jurisdictions which would assist the New Zealand courts in maintaining a balance between taxpayers and the CIR.

## **2. A BRIEF HISTORY OF SECTION BG 1. OF THE ITA AND SIGNIFICANT RECENT CASES**

### **2.1. Introduction**

During the last five years, the Privy Council have considered the application of section BG 1 in three cases:

- *CIR v Challenge Corporation Ltd.*<sup>1</sup>;

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<sup>1</sup> (1986) 8 NZTC 5,219.

- *CIR v Auckland Harbour Board*<sup>2</sup>; and
- *O'Neil v CIR*<sup>3</sup>.

In addition to those three cases, the Court of Appeal has considered the application of section BG 1 in two additional cases:

- *Dandelion Investments Ltd v CIR*<sup>4</sup>,
- *CIR v BNZ Investments Ltd*.<sup>5</sup>

The facts of those five cases indicate that taxpayers have sought to take advantage of a number of the key reforms enacted during the last 30 years. These five cases provide a useful backdrop to consider how the Privy Council and the Court of Appeal have applied section BG 1 to an increasing range of tax planning arrangements.

## 2.2. Income Tax Assessment Act 1891

An examination of the history of section BG 1 will illustrate that the current section has not been significantly altered since it was first enacted as section 40 of the Land and Income Tax Assessment Act 1891. That provision provided that any covenant or agreement that purported to alter the nature of an estate or interest in land for the purpose of defeating the payment of tax was void and of no effect.

## 2.3. Land And Income Tax Act 1900

Section 82 repealed section 40. It is the origin of the current section BG 1.

*“Every contract, agreement, or arrangement made or entered into, in writing or verbally, ... 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 directly or indirectly altering the incidence of any tax, or relieving any person from liability to pay any tax or make any return, or defeating, evading, or of avoiding any duty or liability imposed on any person by this Act, or preventing the operation of this Act in any respect”*

All of the essential elements in the current section BG 1 and its associated definitions are contained in this provision. Section 82 was re-enacted in identical terms in the Land and Income-Tax Act 1908 and in the Income Tax Act 1916. Section 170 of the Land and Income-Tax Act 1923 and section 108 of the Land and Income-Tax Act 1954 were based on this provision.

## 2.4. The 1968 Amendment

In 1968 the original section 82 was amended to provide that any arrangement was void:

*“as against the Commissioner for income tax purposes.”*

The style of drafting was modified but the essential elements remained the same. Section 108 of the Land and Income Tax Act 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*

<sup>2</sup> (2001) 20 NZTC 17,008. The facts are summarised at 5.1. and Diagram 2.

<sup>3</sup> (2001) 20 NZTC 17,051. The facts are summarised at 5.2. and Diagram 3.

<sup>4</sup> (2003) 21 NZTC 17,293.

<sup>5</sup> (1986) 8 NZTC 17,292.



*purpose or effect of in anyway altering the incidence of income tax, or relieving any person from his liability to pay income-tax”*

## 2.5. The 1974 Amendment

For the purposes of this working paper the main change was the relegation of the “Newton predication Test’ of ordinary family or business dealing as an automatic defence.

## 2.6. The Facts In Peterson v CIR

### 2.6.1. A Leveraged Investment

The taxpayer made a passive investment in a film known as *Lie of the Land*. He and a number of other investors invested a total of \$2.760 m in a film that was never released commercially.

The essential facts are outlined in the following diagram.

<INSERT DIAGRAM ONE HERE>

The intuitive tax consequences of that investment would range from no deduction (on the grounds the expenditure is of a capital nature) to a deduction for 100% of the expenditure (authorised under an incentive provision). However the actual tax and cash consequences were as follows:

Total expenditure which comprised of the following 2 items	\$2.760m
Cash provided by taxpayers (43% of total expenditure)	\$1.200m
LIMITED RECOURSE LOAN (57% of total expenditure)	\$1.560m
Tax saving at 66% of total expenditure of \$2.760m	\$1.820m
LESS cash investment	(1.200m)
<b>NET CASH PROFIT</b>	<b><u>\$0.620m</u></b>

The key attraction to an investor of the tax deductions attributable to a non recourse loan is easily demonstrated by an investment of \$10,000 which is funded 43% by the investor's cash and the remaining 57% by a limited recourse loan. The \$5,700 non recourse loan would theoretically constitute a loss to the vendor. However irrespective of whether the film was to succeed or fail, an investor on a marginal tax rate of 66% will obtain a tax saving of \$6,600. In view of the fact that the investor's cash cost was only \$4,300, the investor will at worst derived a cash profit of \$2,300 from the unsuccessful investment. The prima facie return derived by the investor is 53% (\$2,300 / \$4,300). Assuming that the investment is made on the last day of the financial year ie 31 March, and that the investor receives the appropriate tax refund within say two months of balance date the actual return is 320% (\$2,300 / \$4,300 × 12 months/2 months). Clearly the investors in Peterson could not lose and only stood to gain from any commercial and financial success associated with the film investment.

### 2.6.2. The Circular Funding/Limited Recourse Loan

The primary reason why the CIR was prepared to argue this case before the Privy Council was the tax advantages associated with a limited recourse loan, which was essentially financed a circular self-cancelling transaction. This had the tax effect of inflating the allowable deductions.

The essential features of both films were that they were sold to the investors on the understanding that the cost would be an amount that consisted of two inter-related

elements. Throughout this Working paper, the algebraic notation adopted by the Privy Council has been followed. The actual cost of the film was a sum of money described as  $\{ \$x \}$ . However, the investors were led to believe that the actual cost was  $\{ \$x + \$y \}$ .

Item  $\$x$  was the actual cash invested by the investors and this comprised 43% of the total amount. Item  $\$y$  consisted of a limited recourse loan which funded the remaining 57% of the total cost. The case revolved around the deductibility of item  $\$y$  and the fact that the amount of the limited recourse loan was not used in the production of either film. The limited recourse loan was circular funding which had the effect of leveraging the available deductions that were claimed by the taxpayers. The above diagram shows that the taxpayers received (or were treated as receiving)  $\$y$  and paying (or were treated as paying)  $\$y$  together with  $\$x$  to the production company under the contractual arrangements which enabled the taxpayers to purchase the two films. However, the production company only applied  $\$x$  in the making of either film. The production company never used  $\$y$  to produce the film because that amount was recycled to the lender immediately after it was received by the taxpayers.

## **2.7. The Facts In CIR v Auckland Harbour Board**

The Auckland Harbour Board (AHB) owned government and local body financial arrangements. As a result of an impending government reform they were required to transfer assets including \$20 million of government and local authority stock to the Auckland Regional Council (ARC). To avoid the forced transfer of some of the stock, AHB formed inter alia a charitable trust and transferred the stock at 'nil' consideration to the two trusts. AHB made a base price adjustment on this stock on the basis that nothing had been received for it. As a result, AHB claimed a tax deduction of \$8.6 million for the loss created under the base price adjustment. The CIR claimed that the transfer or gift had the effect of defeating the intent and application of the accrual rules. The essential facts are summarised in the following diagram.

<INSERT DIAGRAM TWO HERE.>

Despite the obvious tax advantages arising from the arrangement the CIR failed to convince the Court of Appeal and the Privy Council that the specific anti-avoidance provision should apply. For the purposes of this Working paper, it is assumed that the general and the specific anti-avoidance provisions are the same. The Court of Appeal found in favour of AHB and the Privy Council upheld the views of the majority in the Court of Appeal. The transaction did not have the purpose or effect of defeating the accrual regime because the tax deduction created by the gift was a tax outcome contemplated by the Income Tax Act 1994 (ITA 1994).

## **2.8. O'Neil v CIR**

The essential facts are summarised in Diagram 3 below. The taxpayers were shareholders in a trading company that participated in a scheme that involved a loss company controlled by JG Russell acquiring the trading company. The net profit before tax was paid to the loss company as an administration fee which was offset against the available losses of the loss company. The taxpayers received back the net profit in the form of the 'sale' price for the trading company they had 'sold' to JG

Russell. This was intended to constitute a tax-free gain. The timing of the payment of the purchase price was linked to the underlying profitability of the company and the transfer of the gross profit (as a management fee) to the tax loss company. Finally, there was an option arrangement that enabled the taxpayers to repurchase their company back from the loss company for a nominal amount.

<INSERT DIAGRAM THREE HERE.>

The CIR considered that the purpose and effect of the arrangement was tax avoidance, and applied the general anti-avoidance rule to void the arrangement and re-assessed the profit-making company tax they would otherwise have paid in the absence of this arrangement.

The Court of Appeal held the re-assessments were valid as the CIR held wide reconstructive powers under the anti-avoidance provisions. The Privy Council upheld the Court of Appeal's decision. The approach taken by all the Court's was that the arrangement involved the 'sale' and ultimate 'repurchase' of a business in a manner which was inconsistent with the general core provisions of the ITA 1994, which govern assessable income, allowable deductions, and the taxation of companies. Unlike, for example, in *Westmoreland Properties* or *Auckland Harbour Board*, there were no specific provisions in the ITA 1994 which the taxpayer had satisfied that could have sanctioned the arrangement.

## **2.9. Dandelion Investments Ltd v CIR**

This case was about another statutory mismatch involving deductible interest and non taxable dividends. The approach taken by the High Court and the Court of Appeal in this case<sup>6</sup> prima facie suggests that section BG 1 of the ITA can in some circumstances protect the tax base. The following Diagram summarises the main entities and the transactions which they entered into.<sup>7</sup>

< INSERT DIAGRAM FOUR HERE >

Briefly Dandelion Investments was a profitable manufacturing company which prior to entering into the above arrangement derived substantial assessable income. The taxpayer entered into a transaction in 1986 that involved the purchase of all of the share capital in a UK company (UKA) through CT which was financed by a loan of \$2.8m. The UK vendor of the target company lent the money to a Cook Islands company (W) which in turn lent the \$2.8m to three other Cook Island companies (P, B, F). Ultimately the loan finance was returned to a New Zealand company controlled by Euro National (EN) which had originally lent the \$2.8m to the taxpayer.

The tax advantage sought from the arrangement arose from the cash flows shown in Diagram 5:

< INSERT DIAGRAM FIVE HERE >

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6 CIR v Dandelion Investments Ltd (2001) 20 NZTC 17,293 (HC); and Dandelion Investments Ltd v CIR (2003) 21 NZTC 18,010 (CA).

7 This diagram is based on the summary contained in the judgment of the TRA reported as Case U11 (1999) 19 NZTC 9,100, 9,127, and Appendix A attached to the judgement of Tompkins J reported in CIR v Dandelion Investments Ltd (2001) 20 NZTC 17,293, 17,309 (HC).

If one stands back from the series of individual transactions that made up the arrangement, the net effect was that for income tax purposes the taxpayer paid interest of approximately \$570,000 which it sought to deduct from its other income. That expenditure was partly funded by the tax free dividend of approximately \$484,000 which was used to pay most of the interest. The remaining interest was effectively paid from the tax saving associated with the interest deduction. The tax benefit converted what was otherwise a cash loss into a net benefit for the taxpayer. The reasoning of the High Court and Court of Appeal was very brief. Judgement was given in favour of the IRD.

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

The tax mismatch which occurred in this case is based on the same two provisions in the ITA, and the scheme is conceptually similar to what occurred in Dandelion. The Bank of New Zealand (BNZ) made a series of redeemable preference share investments, which are summarised, in Diagram 4 below. They were complicated transactions, which were designed to take advantage of a statutory mismatch that enabled BNZ to claim an interest deduction in respect of borrowed money, which was used to earn exempt income. The relationship between parties is shown in diagram 6.

<INSERT DIAGRAM SIX HERE.>

Interest paid by BNZ to its customers was deductible for tax purposes because of a specific statutory provision, which provided that interest paid on borrowed money used to subscribe for shares in a group company was deductible. BNZ used the money borrowed from its customers to subscribe for shares in Bank of New Zealand Investments Ltd. (BNZI) which was specifically formed to take advantage of this unique rule. BNZI then used the proceeds of the share issue to subscribe for shares in CML, which was an independent arms length company. CML in turn subscribed for equity in offshore companies, who in turn took up equity in New Zealand tax loss companies. The reason for the equity investments was to enable all of the parties to take advantage of the then Sec. CB 10 of the ITA 1994, which provided that all inter-company dividends were tax exempt. The transactions resulted in the funds being deposited with New Zealand and overseas banks and the interest was ultimately repatriated to the taxpayer (i.e. BNZI) as exempt dividends. The CIR attempted to invoke the general anti-avoidance provision and reassess the taxpayer's claim.

The majority of the Court of Appeal found for the taxpayer. An arrangement could not exist in a vacuum. A fundamental prerequisite to the use of the general anti-avoidance provision against a taxpayer was that there must be a contract, agreement, plan or understanding in which the taxpayer was a participant. No such understanding existed.

## **2.11. Recent Tax Shelter Cases**

The decision of the Privy Council in Peterson is prima facie inconsistent with the recent decision of the New Zealand High Court in *Accent Management Ltd. v CIR*,<sup>8</sup> and the earlier decision of the High Court in *Erris Promotions Ltd v CIR*.<sup>9</sup> Both of

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<sup>8</sup> (2005) 22 NZTC 19,027. The facts are summarised at 9.4.1. and Diagram 5.

<sup>9</sup> (2003) 21 NZTC 18,330.

those cases are conceptually similar to Peterson, in that they involve investments made by high net-worth individuals into what the CIR perceived as a highly leveraged tax-driven investment in forestry and computer software. This working paper will also consider how the Court of Appeal is likely to review the decisions of the High Court in light of Peterson.

In November 2004, the New Zealand High Court held, in *Accent Management Ltd. v CIR*<sup>10</sup> that investors in the forestry transaction known as the Trinity Scheme had deliberately avoided paying income tax and the arrangement was void under Section BG 1 of the ITA. According to the IRD, the scheme was New Zealand's largest tax avoidance arrangement with a potential loss of revenue of more than \$3 billion over a 50-year timeframe. The High Court agreed with the CIR's submission that the dominant purpose of the arrangement was tax avoidance on the grounds that the novel method of measuring and allocating the costs of a Douglas fir forest effectively allowed the taxpayers to claim tax deductions in the 1997/98 income year for expenditure that they would not pay until the trees matured in 2047.

The judgment was given prior to the decision of the Privy Council in *Peterson*. Secondly, the decision of the High Court does not contain an adequate analysis of the underlying legislation and is therefore inconsistent with the earlier decisions of the Privy Council in *Auckland Harbour Board* and *O'Neil*, and the decision of the Court of Appeal in *BNZ Investments Ltd.*

#### *2.11.1. The Basic Structure*

The taxpayer invested in a LAQC. This entity was chosen as the investment vehicle because the losses incurred by the company can be attributed to the shareholders based on their respective shareholding. However, the legislation only permits a maximum of five shareholders per LAQC. Accordingly the LAQCs were arranged into a number of partnerships, which in turn were linked together to form an unincorporated joint venture called Southern Lakes Forestry joint venture (SLFJV).

SLFJV appointed a company to act as its agent to enter into various contracts with a group of companies known as the Trinity Foundation. An important building block in the Trinity Foundation was a charitable trust known as Christian Services Charitable Trust (CSCT), which was incorporated in the Caymans Island (a tax haven). The purpose of the CSCT was to ensure that the ultimate proceeds received from the sale of the Douglas fir forests were free of tax because charitable trusts enjoy a tax-free status.

A third and final important building block was an insurance company known as CSI Insurance Group (BVI) Ltd. (CSI), which was incorporated in the British Virgin Islands (a tax haven).

The relationship between the main entities is shown in Diagram 5 below.

<INSERT DIAGRAM FIVE HERE.>

The left hand side of the diagram shows the packaging up of the individual taxpayers into a tax effective combination of LAQCS, partnerships, and a joint venture. The main tax deductions arose from the deferred license and insurance premiums which were payable at the time the forest was harvested in 50 years time.

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<sup>10</sup> (2005) 22 NZTC 19,027.

### 2.11.2. *The Main Contracts And Cash Flow*

SLFJV and the Trinity Foundation group of companies entered into a complex series of integrated arrangements shown in Diagram 5 above as (a). The Trinity Foundation group of companies granted SLFJV a licence to use farmland to grow one rotation crop of Douglas fir trees. SLFJV were required to pay an annual licence fee per hectare to the Trinity Foundation group of companies and a further deferred licence premium per plantable hectare at the end of the 50-year growing cycle. This amount was secured by the issue of promissory notes in favour of the Trinity Foundation group of companies, which in turn were secured by the issue of debentures by a company related to SLFJV.

The cash flows were linked to the 50-year growing cycle of Douglas fir. However, by far, the majority of the expenditure was deferred until the forest was harvested. Most of the expenditure was linked to a right to use farmland and the cash payment for that right was deferred until the forest was harvested. The taxpayers were required to pay an annual licence fee of \$50 per hectare to the Trinity Foundation group of companies and a further deferred licence premium of \$2,050,518 per plantable hectare at the end of the 50-year growing cycle. There were 484 plantable hectares involved in the scheme. Accordingly, payment of the deferred licence premiums amounted to \$992,450,712. The insurance policy issued by CSI was designed to deal with the uncertainty over the market value of the Douglas fir at the end of the 50-year growing cycle. If the market value of the net stumpage of Douglas fir was less than \$2,050,518 per plantable hectare, then the insurance policy covered the shortfall. The SLFJV was required to pay an initial premium of \$1,307 per plantable hectare and \$32,791 per plantable hectare at the end of the 50-year growing cycle.

### 2.11.3. *The Tax Deductions*

The CIR attacked the transaction under Section BG 1 of the ITA because of the mismatch between the cash payments and the tax deductions. In the first year of the project (i.e. 1997), the plaintiffs spent a total of \$4,603 per hectare and achieved a tax deduction of \$37,394 per hectare. For the 1998 income year, in addition to allowable maintenance costs, the plaintiffs spent \$50 per hectare and claimed tax deductions of \$39,560 per hectare. The primary tax deductions were the annual allocation of (1/50<sup>th</sup>) of the licence premium payable in December 2048 of \$2,050,518 per plantable hectare and a similar allocation of the final insurance premium of \$32,791 per plantable hectare which was payable in 2047. This timing mismatch between the claiming of the tax deduction and the payment of the cash is permissible under the general deductibility provision which allows a taxpayer to claim a deduction for expenditure "incurred"<sup>11</sup> irrespective of when the actual cash outlay is made.

### 2.11.4. *Unusual Commercial Features Of The Trinity Scheme*

One of the taxpayer's expert witnesses accepted that he had never seen a financial a structure for a forestry investment that involved a fixed licence premium payable in 50 years time. A second unusual feature was the contractual arrangements between

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<sup>11</sup> The judgement of the Privy Council in *CIR v Mitsubishi Motors New Zealand Ltd* (1993) 17 NZTC 12,351 contains a comprehensive analysis of the leading New Zealand and Commonwealth cases on this important concept.

the landowner and the joint venture taxpayers, which required the joint venturer to plant, manage, and harvest the forest, for the landowner who retained ownership of the trees. A third unusual feature was the insurance arrangements, which were designed to guarantee a price for the forest in 50 years time with a significant deferral of payment of the premium.

## **2.12. Draft Policy Statement On The New Zealand General Anti-Avoidance Rule**

Recently, the Inland Revenue Department (IRD) released a comprehensive discussion document on how they propose to apply the general anti-avoidance rule.<sup>12</sup> That document was released before the Privy Council judgment in Peterson. This working paper will also consider the impact of the Peterson decision on the general approach advocated in the discussion document.

## **2.13. Conclusions**

The broad brush taken in the current section BG 1 can be traced back to the enactment in 1900. If the broad language was literally applied to the facts in cases such as Peterson, Auckland Harbour board, BNZ Investments Ltd, and Dandelion the CIR would have succeeded in depriving those taxpayers of the advantages they obtained from structuring their affairs to take advantage of specific provisions in the ITA. However that did not occur in the first three cases. This suggests that a General Anti Avoidance Rule is likely to become increasingly ineffective in protecting the tax base from arrangements that are based on for example the statutory mismatch which occurred in both Auckland Harbour Board and BNZ Investments Ltd.

## **3. AMENDING LEGISLATION ENACTED SINCE 1974**

Major structure changes to the ITA enacted during the last thirty two years which have been used by taxpayers in the above five cases include the following.

1. The enactment of a comprehensive regime that taxes all gains from financial arrangements,
2. the loss attributing qualifying company regime,
3. liberalisation of the rules governing the deductibility of interest,
4. A depreciation regime which enables taxpayers to deduct the cost of intangible property such as screen play (Peterson) software (Acton) and the right to use land (Trinity).

## **4. THE JUDICIAL APPROACH TO SECTION BG 1 PRIOR TO CHALLENGE CORPORATION**

### **4.1. The Problem of Adopting A Literal Interpretation**

The broad language used in section BG 1 gives this provision an extremely wide theoretical ambit, which could lead to unintended consequences if it was interpreted literally. Should the judiciary read it down and devise a test, which distinguishes between the Courts perception of acceptable and unacceptable tax planning. The answer is yes.

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<sup>12</sup> NZIRD: Public Rulings Unit Adjudication and Rulings, “BG 1 and GB1 of the Income Tax Act 2004: Exposure Draft for External Consultation Reference INA 0009”, [www.taxpolicy.ird.govt.nz/](http://www.taxpolicy.ird.govt.nz/)

The origin of this issue is a statement by Lord Wilberforce in *Mangin v CIR*<sup>13</sup> where he said:

*“[Section BG 1] fails to specify the relationship between that section and other provisions in the income tax legislation under which tax relief or exemptions made 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 a distinction between ‘tax avoidance’ and ‘improper’ tax avoidance? By what sense is this distinction to be perceived?”* (Emphasis added)

In *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 (CA) Richardson J discussed this issue in greater detail. It is important to note the context in which he referred to this problem. *Challenge* involved an arrangement, which clearly satisfied the requirements of the former sections 188 and 191 ITA 1976 (now Subparts IE and IG). His Honour observed that (pp 5,019-20):

*“Clearly the legislature could not have intended that [section BG 1] should override all other provisions of the Act so as to deprive the tax paying community of structural choices, economic incentives, exemptions, and allowances provided for by the Act itself ... In many cases but for the anticipated availability of the tax benefit, the taxpayer would never have entered into the activity or transaction ... It is not the function of [section BG 1] to defeat other provisions of the Act or to achieve a result which is inconsistent with them.”* (Emphasis added)

On appeal in *CIR v Challenge Corporation Ltd* [1987] AC 155; [1986] 2 NZLR 513; (1986) 8 NZTC 5,219 (PC), Lord Oliver of Aylmerton (in the dissenting opinion) reached a similar conclusion stating (p 5,228):

*“In the first place, [the IRD] concede that [section BG 1], albeit expressed in the widest possible terms, has to be read subject to some limitation as regards transactions permitted or authorised by other legislative provisions if it is not to produce results that are absurd.”* (Emphasis added).

Herein lies the difficulty faced by the judiciary. Upon what rationale basis should section BG 1 be read down? The answer to this question carries with it the danger eluded to by Fullager J in *FCT v Newton* (1957) 96 CLR 577, 646; (1957) 7 AITR 1, 50, that:

*“... the purposes or effects which will attract its operation are stated very vaguely. If we interpret it very literally, it will seem to apply to cases which it is hardly conceivable that the legislature should have had in mind. On the other hand, any limitation which we may seek to imply may appear to deprive the section of all practical effect.”*

#### **4.2. Tax Avoidance As An Incidental Purpose**

Prior to the *Challenge* case the main judicial technique for controlling the scope of Section BG 1 was the courts approach to the interpretation of the phrase ‘incidental purpose or effect’ which is contained in paragraph (b) of the definition of ‘tax avoidance arrangement’. Woodhouse P (dissenting) in *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001 (CA) describes this approach as follows (p 5,004):

*“It will be seen that paragraph (a) and (b) of subsection (2) deal explicitly with two different situations. That contemplated by paragraph (a) is where the tax avoidance*

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<sup>13</sup> (1971) NZLR 591, 602.



*purpose or effect of an arrangement stands by itself, as, for example, where the sole end in view is '... reducing ... any liability to pay tax.' The other situation, the concern of paragraph (b) is where there are two or more purposes or effects of an arrangement including the tax avoidance one. However, when that is the position paragraph (b) ensures that the tax avoidance purpose is not to be put aside simply because standing beside it there is another purpose or effect which is related to ordinary business or family dealings. Instead the matter is to be tested by considering whether the tax purpose or effect is or is not something more than merely incidental."*

Woodhouse P went onto comment that the final nine words in paragraph (b) of the definition of tax avoidance enable a merely incidental tax avoidance purpose to be disregarded. He noted (p 5,006):

*"As a matter of construction I think the phrase merely incidental purpose or effect in the context of [section BG 1] points to something which is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant."*

#### **4.3. A Technique For Applying The Incidental Purpose Test**

However, care must be taken over the Newton predication test. Under the old s 108 ITA 1954, the Courts in New Zealand and Australia took the view that an arrangement, which was explainable as ordinary business or family dealing, did not exhibit a tax avoidance purpose. This was the origin of the Newton predication test. However, paragraph (b) of the definition of 'tax avoidance arrangement' now includes the words:

*"... whether or not any other purpose or effect is referable to, ordinary business or family dealing ..."*

This suggests that where there are two or more purposes or effects, one of which is in the nature of ordinary business or family dealing, and one of them is tax avoidance, section BG 1 will apply. Yet, if ordinary business or family dealing can be said to be the only purpose of an arrangement, then it would not be an arrangement with a purpose of tax avoidance. What section BG 1 boils down to is a provision that an arrangement is likely to fall within, if on the face of things, the arrangement would not have been entered into, either in that way, or at all, if tax avoidance had not been an essential consideration. The pursuit of valid commercial objectives is implicit in every arrangement that was entered into by the parties, irrespective of the tax consequences that follow from it.

One useful way of ascertaining whether or not the tax advantages were merely an incidental bonus, rather than an end in themselves, is to ask if the parties would have carried out the arrangement in that way if there would have been no such tax advantages associated with the arrangement?

One method of answering this question is to try and recast or reconstruct the arrangement in such a way that the tax consequences are avoided, but all of the commercial objectives are achieved. If this can be done, then the IRD can raise the obvious point that tax avoidance was not merely an incidental purpose or effect. The logic of this approach would be difficult to refute. The following case supports this approach.

#### 4.4. Loader v CIR (1974) 2 NZLR 472 (HC)

This was a sale and lease back situation. Prior to the incorporation of a company, Mr Loader had carried on business on his own account. He owned all the assets and therefore derived all of the income. Shortly after setting up the company, he sold all his earthmoving machinery to a newly formed family trust, the purchase price being left, interest free, payable on demand. The trust then hired the machines to the company. This rearrangement created a tax saving because (based on the current rates of tax) the company claimed deductions at 33% and the beneficiaries were taxed at 19.8%. Prior to the rearrangement Mr Loader was taxed at 39%. The net tax savings was 20 cents per dollar of income siphoned off to the trust. There were five reasons why the arrangement would have been entered into, even if the income splitting advantage were not available: the advantages of limited liability (the business was risky both physically and financially); the ability to raise debenture finance; the ability to charge the company's book debts; preservation of capital assets within the family unit; and estate duty considerations. None of these reasons are referable to income tax considerations. For these reasons it is not surprising that Cooke J (as he then was) found himself (p 477):

*"Satisfied that an arrangement on the general lines adopted would have been desirable irrespective of taxation advantages; while as they agreed, such advantages would add to its attractions".*

His Honour was able to conclude that the tax advantages were merely an incidental effect; part and parcel of the arrangement to achieve those five commercially realistic and valid "non taxation" purposes. This was despite the fact that there was little or no change in the business activities, which continued as before.

In view of the foregoing, the question of adopting an alternative business structure never arose in Loader. But this point worried Cooke J (p 478):

*"Having considered Mr Stone's argument overnight in the light of the authorities, I asked him this morning whether, assuming that tax saving was one purpose of the arrangement, it was accepted that the purposes also included:*

- *The advantages of incorporation;*
- *Preservation of valuable assets for the family;*
- *Saving estate duty.*

*Counsel said that this was accepted and that it was agreed that these are ordinary considerations in business or family dealing; but he reiterated the Commissioner's contention that tax saving was the principal purpose. He acknowledged that to achieve the three objects just mentioned either the entire arrangement or some substituted arrangement would have been needed, even if tax saving had not been in mind at all. For instance, both company and trust were vital, unless an equally effective substitute could be found for either. This incidentally, had been emphasised by Sir Clifford Plimmer and Mr Pope. Counsel said that the Commissioner did not feel obliged to point specifically to any alternative way in which the same result could have been achieved. That attitude is understandable."* (emphasis added)

If the CIR had pointed to an alternative structure, which did not carry with it the features of income splitting, and inflated deductions, the result may have been different as in the case of *Tayles v CIR* [1982] 2 NZLR 726; (1982) 5 NZTC 61,311 (CA).

#### **4.5. Other Examples Of The Incidental Purpose Test**

The approach to the application of section BG 1 in these two decisions can be traced into the following broad categories.

1. Income splitting via the creation of additional deductions,
2. Income splitting via the inflation of allowable deductions,
3. Sale and lease back transactions to create deductions,
4. Conversion of income into a non taxable receipt,
5. Income splitting via a related party such as a trust.

However this technique will not be adequate to deal with arrangements that are deliberately structured to take advantage of provisions in the ITA which confer a tax advantage. Challenge was the first case where this problem arose and for that reason it can be classified as a land mark decision.

### **5. THE PRIVY COUNCIL JUDGEMENT IN CHALLENGE CORPORATION**

#### **5.1. Significance Of The Case**

Challenge was the first New Zealand case which involved an arrangement that deliberately sought to take advantage of two specific provisions in the ITA 1976 which govern the carry forward and offsetting of tax losses between groups of companies. Previous cases essentially involved family arrangements and the general core provisions in the ITA which govern the calculation of allowable deductions and assessable income. Challenge is conceptually similar to the other recent decisions of the Court of Appeal and Privy Council discussed in this working paper. It is also significant because the approach taken by the majority of the Court of Appeal can be traced through into all of those recent decisions. The majority of the Privy Council overrode the majority of the Court of Appeal and introduced a novel approach to the application of section BG 1.

#### **5.2. The Essential Facts**

The taxpayer challenge Corporation purchased all of the share capital of a loss company known as Perth. There was no commercial justification for that transaction because:

1. At the time of the sale Perth was a dormant company which was not trading.
2. Perth did not at any stage engage in any form of business activity after the sale. It was never envisaged that Perth would undertake any activity within the Challenge group of companies.
3. Perth owns no other valuable assets of any kind apart from the available tax losses.

For these reasons to purchase price was \$10,000 or 22.5% of the available tax losses of \$5.8 million which had been incurred by Perth.

The advice of the majority was delivered by Lord Templeman who after summarising the facts concluded at page 5,223 that;

*A clearer case for the application of section Section BG 1 cannot be imagined. If such an arrangement were not caught by Section BG 1 and were recognised by the Courts for tax purposes, income tax would only be collected from those profitable companies which fail to come to terms with loss-making companies."*

### **5.3. The Approach Of The Majority Of The Privy Council: Lord Templemans Advice**

For the purposes of this working paper the main point to note in Lord Templeman's approach is that he introduced the distinction between tax avoidance and tax mitigation. He said that income tax is mitigated by taxpayer who reduced his income or incurred expenditure in circumstances which reduced the taxpayer's assessable income or entitled the taxpayer to a reduction in his tax liability. Section BG 1 did not apply to tax mitigation because the taxpayer's advantage is not derived from an arrangement, but from the reduction of income which he accepts or the expenditure which he incurs. By way of contrast he said that income tax is avoided and a tax advantage is derived from an arrangement where the taxpayer reduces his liability to tax without involving him in the expenditure or loss which entitled him to that reduction. A taxpayer who engages in tax avoidance does not reduce his income or suffer a loss or incurred expenditure but nevertheless obtains a reduction in his liability to tax as if he had.<sup>14</sup>

### **5.4. Application Of The Distinction To The Facts Of Challenge**

At one level of analysis the taxpayer was in a position to argue that they had complied with the technical requirements of the relevant legislation and had therefore incurred the requisite expenditure within the meaning of Lord Templeman's test. Challenge had paid Perth (the owner of the losses) 22.5% of \$5.8 million ie \$1,305,000 which in turn saved Challenge tax of \$2.850 million.

However, that was not what Lord Templeman meant by the distinction between tax mitigation and tax avoidance. He said at page 5233:

*Section 191 (of the 1976 Act) was intended to give effect to the reality of group profit and losses. When one member of a group makes a profit of \$5.8 million and another member of the group makes a loss of \$5.8 million then the reality is that the group has made neither a profit nor a loss and that the members of the group should not be liable to tax. Section 191 in these circumstances is not an instrument of tax avoidance. But in the present circumstances the reality is that the Challenge group never made a loss of \$5.8 million. A loss of \$5.8 million was made by Perth and that loss fell on Merbank before Challenge contracted to buy Perth (from Merbank). Section 191 and these circumstances is an instrument of tax avoidance which falls foul of section 99 (of the 1976 Act)."*

What Lord Templeman is effectively saying is that under the original version of section 191 of the ITA 1976 there was a "natural law" of company groups equivalent to the law after the 1980 amendments which said that if you were not in a group of companies at the time our loss was incurred you could not offset the loss against the income of other members of the group.

### **5.5. Implications Of Lord Templeman's Approach**

If Lord Templeman is correct in that the original section 191 could only be invoked by groups of companies which were in existence at the time the loss was incurred then there does not appear to be any role for section BG 1. He reached that conclusion by

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<sup>14</sup> (1986) 8 NZTC 5,219 at page 5,226.

focusing on the original section 191 (of the ITA 1976) and ascertaining that there was this natural unwritten law of grouping for companies which provided that if the profit company was not a member of the loss company's group at the time the loss company incurred the loss then the profit company could not utilise the loss companies losses.

#### **5.6. The Approach Of Richardson J In The Court Of Appeal**

His Honour 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 section BG 1 could not be invoked by the Commissioner because the income tax consequences of the transaction were contemplated by the Act. 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. This analysis has subsequently become known as *the scheme and purpose approach* to the application of section BG 1 where the answer is based on an interpretation of all of the relevant provisions, and any amendments, to see 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 effect Challenge’s liability for income tax in the sense indicated by the Statute.”* (Emphasis added)

This working paper will trace the emergence of this interpretative approach into the dominant judicial technique for controlling the application of section BG 1 of the ITA.

## **6. THE CURRENT JUDICIAL APPROACH TO SECTION BG 1: THE JUDGEMENT IN PETERSON v CIR**

### **6.1. The Majority Judgment**

Lord Millet delivered the majority judgment, which held that the actual amount paid as consideration for the production of the two films was deductible under the depreciation regime. His Lordship held that the transactions could not be struck down by Section BG 1 of the ITA merely because the taxpayers were clearly influenced by the tax advantages associated with the investment. The majority followed the earlier decision of the Court of Appeal and Privy Council in *Challenge Corporation Ltd*<sup>15</sup>. In the context of the highly leveraged film investment, Section BG 1 of the ITA would only apply if the taxpayers had reduced their income tax liability without incurring the expenditure that created the tax deduction. The fact that approximately half of the purchase price was funded by a limited recourse loan did not mean that the taxpayers had not suffered the economic cost of paying the agreed upon purchase price for the two films. The fact that the production company made a secret profit as a result of the circular funding was also irrelevant.

However, Lord Millet suggested in obiter that the CIR could have applied the general anti-avoidance provision if it was established that the limited recourse loan contained uncommercial terms. If that had occurred, it may have been possible for the CIR to have apportioned the consideration paid for the acquisition of the film and disallowed the deduction to the extent it was financed by the limited recourse loan.

### **6.2. The Minority Judgment**

Lord Bingham of Cornhill and Lord Scott of Forscote found in favour of the CIR and held that Section BG 1 of the ITA applied. The minority were unable to support the finding of the majority that the taxpayers had suffered the economic burden of paying the purchase price for the two films. Unlike the majority they were prepared to examine the circular nature of the limited recourse loan by focusing on what actually happened to the money after it was paid by the taxpayers to the producer of the two films.

### **6.3. A Common Approach**

The main difference between the approach of the majority and the minority was over the interpretation of certain aspects of the facts. The primary difference was over the extent to which the Court should have regard to the circular funding which was provided by a limited recourse loan.

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 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 what are known as structural choices and economic incentives contained in the ITA. This has been described by the Privy Council in earlier judgments as the “scheme and purpose approach” to the interpretation of the general anti-avoidance rule, which is based on the ITA’s legislative pattern.

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<sup>15</sup> (1986) 8 NZTC 5,001.

Secondly, both judgments agreed that there is no requirement that the taxpayer must be aware of all aspects of the arrangement before the CIR can invoke the general anti-avoidance rule. This aspect of the case overturns the earlier judgment of the Court of Appeal in *BNZ Investments Ltd.*<sup>16</sup> This now means the anti-avoidance provision can apply where a tax advantage is enjoyed by someone who is not a party to the arrangement, or by a taxpayer who has no knowledge of the details of the arrangement.

#### **6.4. Amending Legislation**

Recently, specific rules were introduced into the ITA to overcome the tax benefits associated with limited recourse loans and highly leveraged investments. Secs. GC 29 to 31 of the ITA contains what is known as the deferred deduction rule.<sup>17</sup> The effect is to limit the tax deductions of an investor to the actual funds that the taxpayer has at risk in the scheme. To the extent that the deductions are attributable to limited recourse finance, they are deferred until the scheme is commercially successful. If the scheme is a financial failure, the deferred deduction becomes permanent.

#### **6.5. Analysis Of The Judgement**

##### *6.5.1. A Common Approach*

The approach of the majority and minority was conceptually similar, but differed over the interpretation of the facts. Both judgments agreed that Section BG 1 of the ITA could apply where a tax advantage is enjoyed by a taxpayer who was not a party to the arrangement which created the tax advantage. Furthermore, the taxpayer who obtains the advantage does not need to know of the specific details of that arrangement.

Both judgments agreed that the CIR cannot 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. The origins of this approach can be traced back to the decision of Richardson J (as he then was) in *Challenge Corporation Ltd.*<sup>18</sup> This approach was also followed by the Privy Council in the recent cases of *Auckland Harbour Board*<sup>19</sup> and *O'Neil*.<sup>20</sup> In *Challenge Corporation Ltd.*, Richardson J said:<sup>21</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.”*

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<sup>16</sup> The facts of *BNZ Investments Ltd.* are summarised at 5.3. and Diagram 4.

<sup>17</sup> For a discussion of the legislation, please refer to AMC Smith and DG. Dunbar, “*Tax Avoidance Schemes and New Zealand Limited Recourse Loans and the Deferred Deduction Rule*”, 59 Bulletin for International Fiscal Documentation 6, Pgs. 249-257, International Bureau of Fiscal Documentation.

<sup>18</sup> (1986) 8 NZTC 5,001.

<sup>19</sup> The *Auckland Harbour Board* facts are summarised at 5.3. and Diagram 4.

<sup>20</sup> The *O'Neil* facts are summarised at 5.2. and Diagram 3.

<sup>21</sup> (1986) 8 NZTC 5,001 at pg. 5,019.

This passage was cited with approval in the minority judgment of Lord Bingham of Cornhill and Lord Scott of Foscote.<sup>22</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>23</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.”*

#### 6.5.2. The Scheme And Purpose Approach To Section BG 1 Of The ITA

Lord Millet<sup>24</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.

This is the most significant aspect of the Peterson decision. 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.

#### 6.5.3. Knowledge Of The Tax Advantage Is No Longer A Requirement: CIR v BNZ Investments Ltd

The application of Section BG 1 of the ITA depends on a finding that the taxpayer was a party to an arrangement. In BNZ Investment Ltd. (which was an earlier decision of the Court of Appeal), the majority adopted a restrictive interpretation of the word ‘arrangement’. They held that there must be a meeting of the minds between the parties to the arrangement and that there must be an expectation as to what will occur in the future, in other words a consensus as to what will be done. Richardson J. held:<sup>25</sup>

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<sup>22</sup> (2005) 22 NZTC 19,098 per Lord Millett, para. 61 at pg. 19,119.

<sup>23</sup> (2005) 22 NZTC 19,098, para. 35 at pg. 19,109.

<sup>24</sup> *Ibid*, para. 36 at pg. 19,109.

<sup>25</sup> (2001) 20 NZTC 17,103, para. 51 at pg 17,117.



*“... the justification for construing the concept of the arrangement in that way is that it would be inequitable for a taxpayer who enters into an apparently unobjectionable transaction to be deprived of its rights there-under merely because, unknown to the taxpayer, the other party intended to meet its obligations under that transaction, or in fact did so, in a legally objectionable way ... In order to avail the Commissioner, the consensus - the meeting of minds - necessary to constitute an arrangement under [section BG1] must encompass explicitly or implicitly the dimension which actually amounts to tax avoidance; albeit the taxpayer does not have to know that such dimension amounts to tax avoidance.”*

Lord Millet rejected the approach taken by the majority of the Court of Appeal in BNZ Investments Ltd. He held:<sup>26</sup>

*“... their Lordships are satisfied that the “arrangement” which the Commissioner has identified had the purpose or effect of reducing the investors liability to tax and that, whether or not they were parties to the “arrangement” or the relevant part or parts of it, they were affected by it. Their Lordships do not consider that the arrangement requires a consensus or meeting of minds: the taxpayer need not be a party to the “arrangement” and in their view he need not be privy to its details either.”*

This approach to the interpretation of the concept of an arrangement amounts to a significant increase in the potential scope of Section BG 1 of the ITA.

Lord Bingham reached a similar conclusion but adopted a different path of reasoning. He agreed with Richardson J. and the majority of the Court of Appeal in BNZ Investments Ltd. that the definition of an “arrangement” requires a meeting of the minds or a consensus. However he held that in the case before the Privy Council this requirement was not necessary because of the clear statement in subsection 3 of the definition of “arrangement” that Section BG 1 of the ITA also applies to a taxpayer who obtains a tax advantage but was not a party to the arrangement which created the tax advantage.

## **6.6. Application Of The Scheme And Purpose Approach To The Facts In Peterson v CIR**

The essential difference between the approach of the majority and the minority was over how in their respective judgements they interpreted the scheme and purpose of the depreciation regime. According to the majority the entitlement to a depreciation deduction depends on the taxpayer establishing that they incurred the cost of acquiring an asset. The majority adopted a form, as opposed to a substance, approach to answering this important question. In their opinion the answer did not depend on how the taxpayers choose to finance the asset or on what the vendor spent the purchase price on. Lord Millet said at paragraph 39:

*“... investors in films are entitled to depreciate their acquisition costs. This is so however much the film actually costs of Production Company to make and by whatever means that investors have obtained the funds to finance the acquisition.”*

His Lordship was not prepared to read in an additional requirement that the taxpayer must show that the vendor of the film spent the proceeds on making the film purchased by the taxpayer.

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<sup>26</sup> (2005) 22 NZTC 19,098, para. 34 at pgs. 19,108-109. The facts are summarised at 5.3. and Diagram 4 9.4.5.

The minority adopted a substance-based approach to the interpretation of the depreciation regime. They were prepared to read in a requirement that, where the proceeds of a limited recourse loan were not used to meet the cost of the film the deduction should be reduced by that amount. In the final paragraph of the judgment, Lord Bingham held the issue was whether the Courts, in deciding if Section BG 1 of the ITA could be applied:<sup>27</sup>

*“... to reverse the undoubted tax advantage that would otherwise be claimable, must shut their eyes to what happened to the \$y after it had left the hands of the investor. The majority have taken the view that is the position. But in our opinion so to hold would deprive [section BG1] of its proper effect in relation to transactions such as these. If the later events showed that the money, \$y, had nothing to do with the cost of production of the film, and nothing to do with the price that the vendor of the film wanted to extract for the rights in the film that he was selling, but was simply a means of boosting the depreciation allowance that could be claimed, we find it extraordinary to rule out the application of [section BG 1].”*

### **6.7. Limited Recourse Loans**

The majority accepted that there are no conceptual differences between expenditure which is:

- funded from the taxpayer's own resources;
- from a full recourse loan; or
- a limited recourse loan.

They correctly concluded that expenditure funded from limited recourse loans is treated the same as any other borrowing. The position is now different due to the deferred deduction regime.

Circularity of funding is a commercial commonplace. When a purchaser acquires an asset through vendor finance, a circular cash flow takes place between the vendor in its capacity as lender, to a borrower, and from the purchaser to the vendor by way of application of the borrowed funds in discharge of the purchase price obligation. In neither tax nor non-tax contexts, therefore, is the fact of circularity of funding itself of particular relevance. What is of more significance in a tax enquiry is whether the borrowing, which commences that circular flow, gives rise to legally enforceable obligations on the part of the borrower to make repayments of principal and interest. If that is the case, then the fact that the borrower claimed a tax deduction for the expenditure of the borrowed funds through their payment to either the lender in its capacity as vendor, or a party associated with the lender/vendor, is of no particular significance.

Lord Millet's judgment provides powerful support for the proposition that the presence of a limited recourse loan does not of itself trigger Section BG 1 of the ITA. In the context of the New Zealand depreciation regime his Lordship noted:

*“The fact that the cost of acquisition is funded wholly or in part by a non-recourse loan ought ordinarily to be irrelevant. [28] The fact that the investment was funded by a non-recourse loan did not alter the fact that the investors had suffered the economic burden of paying the full amount of the \$x + \$y. It was not and could not*

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<sup>27</sup> Ibid, para .101 at pg. 19,123.

<sup>28</sup> Para. 15 at pgs. 19,104–105.

*be suggested that either loan was on terms which meant that it was unlikely ever to be repaid. Investors have repaid one of the loans in whole or in part, albeit out of film receipts; and they incurred a liability to repay the other if the film generated sufficient receipts, as it was hoped that it would.*<sup>29</sup>

#### 6.7.1. Decisions Of The House Of Lords On Limited Recourse Finance: *Plummer v IRC*

Support for this approach can be found in Lord Wilberforce's speech in *Plummer*.<sup>30</sup>

In that case, a charity paid a taxpayer a day-one sum of GBP2,480 in return for the taxpayer's commitment to pay an annuity to the charity of an amount of GBP500 for a five-year period. It was a term of payment of the GBP2,480 that the sum was to be spent by the taxpayer on the purchase of promissory notes in GBP500 denominations for a total value of GBP2,500, and that those notes would be lodged with the charity as security for the payments. The arrangement was entered into exclusively to derive taxation benefits, i.e. the GBP500 was deductible to the taxpayer.

It is difficult to imagine a more "circular" arrangement. On any substantive analysis, the same GBP2,480 received from the charity was applied (together with a small top-up by the taxpayer) to acquire the promissory notes lodged with the charity as security for payment of the annual sums. The House of Lords held in favour of the taxpayer's claim to a deduction for the annuity payments

#### 6.7.2. *MacNiven v Westmoreland Investments Ltd.*<sup>31</sup>

The approach in *Plummer* is supported by the recent decision of the House of Lords in *Westmoreland Investments Ltd.*, which is a "fiscal nullity" (tax avoidance) decision. Briefly, the facts were that the taxpayer had made a number of unsuccessful investments in real property during the 1970s using funds borrowed from the sole shareholder. By the late 1980s, *Westmoreland Investments Ltd.* (WIL) was dormant and insolvent. It owed more than GBP70 million to its parent company including over GBP40 million of accrued interest. None of this interest expense had been deducted for tax purposes because the law required that non-bank interest be paid before a tax deduction could be claimed. Accordingly, the shareholder made several interest-free loans to WIL, which were used to pay accrued interest to the shareholder. In each case, WIL was required to withhold tax from the interest payment, but the shareholder were able to reclaim the withholding tax because of its status as a tax-exempt superannuation scheme. The transactions were perfectly circular cash flows and they created a large loss, which could be carried forward. Subsequently WIL was sold to an unrelated property developer for GBP2 million. Despite the circular nature of the transactions the House of Lords held the interest was deductible for tax purposes.

Lord Hoffman observed:<sup>32</sup>

*"The dispute between the taxpayer and the Crown is whether the interest was "paid" within the meaning of section 338 [of the Finance Act 1968]. It arises because [the*

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<sup>29</sup> Para. 44 at pgs. 19,110–111.

<sup>30</sup> (1979) 3 All ER 775. This case was decided before *Ramsay*.

<sup>31</sup> (2001) 2 WLR 377.

<sup>32</sup> *Ibid.* At pg. 393.

*taxpayer] paid the interest out of money which it had been lent by the lender for the specific purpose of enabling it to pay. The interest liability was replaced by a liability for an additional capital sum. The transaction was circular. [The taxpayer] borrowed money and paid it back as interest. And the only purpose of the transaction was to produce an allowable deduction for corporation tax.”*

The House of Lords held unanimously that neither Ramsay<sup>33</sup> nor any subsequent House of Lord’s fiscal nullity decision provided any basis for treating the interest as other than having been “paid”. This view was seen to conform with the literal, legal, and business, meanings of the term “paid”. The consideration that payment arose from a transaction entered into for the purpose of obtaining a tax advantage was irrelevant in these circumstances.

## **7. SCHEME AND PURPOSE APPROACH: STRUCTURAL CHOICES**

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

There is an uneasy relationship between Section BG 1 and all the other provisions in the ITA. The judiciary are clearly aware of the problem an anti-avoidance provision creates. What is the relationship between Section BG 1 of the ITA, 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.<sup>34</sup> observed that:

*“The fundamental difficulty lies in the reconciliation of different and conflicting objectives. Clearly the Legislature could not have intended that [section BG 1] should override all other provisions of the Act so as to deprive the tax paying 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 never have 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. On the other hand, [section BG 1] would be a dead letter if it were subordinate to all specific provisions of the legislation ... It is inherent in [section BG 1] that but for its provisions the impugned arrangement would meet all the requirements of the income tax legislation ... [section BG 1] 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] 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***

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<sup>33</sup> The decision of the House of Lords in *Ramsay* is viewed by most commentators as the origin of the fiscal nullity doctrine.

<sup>34</sup> (1986) 8 NZTC 5,001 (CA)

**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)

## **7.2. 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, as follows:

### **7.2.1. 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.

### **7.2.2. 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 Secs. IF 1 to IF 5 and Secs. 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>35</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 chose between the diminishing value and straight line methods.<sup>36</sup>

### **7.2.3. Category 3 – Tax Incentives**

Prior to the election of the Labour Government in 1984, the Income Tax Act 1976 (ITA 1976) contained numerous incentive provisions such as accelerated depreciation write-offs, tax credits and tax deductions for exporters, standard values for farmers, and a preferential taxation regime for certain categories of superannuation schemes. Very few remain. They are confined to specific regimes such as the taxation of petroleum, mining and forestry.<sup>37</sup>

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

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<sup>35</sup> Refer to Part HG of the ITA for further details.

<sup>36</sup> Refer to Part EE of the ITA for further details.

<sup>37</sup> Refer to Part EJ of the ITA for further details.

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 contain 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.

### 7.3. The 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 choice principle. This is 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 necessarily overruled by Section BG 1 of the ITA. The taxpayer has simply exercised choice expressly made available to him by the New Zealand Parliament. The leading Australian cases include:

- W P Keighery v FCT;<sup>38</sup>
- Casuarina Pty Ltd v FCT;<sup>39</sup>
- Mullens v FCT;<sup>40</sup>
- Slutzkin v FCT;<sup>41</sup> and
- Cridland v FCT.<sup>42</sup>

In Challenge Corporation Ltd., Richardson J. discussed with approval the above Australian cases and summarised their applicability in New Zealand as follows:<sup>43</sup>

*"It is the principle which is important and Keighery 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

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<sup>38</sup> (1957) 100 CLR 66.

<sup>39</sup> 71 ATC 4068.

<sup>40</sup> (1976) 135 CLR 290.

<sup>41</sup> (1977) 140 CLR 314.

<sup>42</sup> (1977) 140 CLR 330.

<sup>43</sup> (1986) 8 NZTC 5,001 at pg. 5,023.

## **8. RECENT EXAMPLES OF THE THREE CATEGORY CLASSIFICATION**

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

Fifteen years after Challenge Corporation Ltd., Richardson J repeated this approach in BNZ Investments Ltd. Given what happened in Auckland Harbour Board, and the rejection in O'Neil of tax mitigation, this is likely to become the decisive interpretative technique. In BNZ Investments Ltd., Richardson J observed that<sup>44</sup>:

*The function of [section BG 1] 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] 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 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."*

### **8.2. 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 would have won.

Why did the IRD lose? The answer is that the taxation of financial arrangements is category two legislation and taxpayers are free to exploit any loopholes. It was as blatant as what happened in Challenge Corporation Ltd., yet the taxpayer won. The key steps in Lord Hoffmann's judgement in Auckland Harbour Board can be seen in the following propositions:

- The financial arrangements were taxable in accordance with a comprehensive statutory regime.
- 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.
- 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.
- The CIR accepted that the loss arising from the gift was an automatic deduction under the statutory formula.
- The CIR accepted that the legislation contained no over riding discretions.
- 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 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*

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<sup>44</sup> (2001) 20 NZTC 17,103, para. 40 at pg. 17,115.

*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 Jenkin 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)*

### **8.3. O’Neil v CIR**

Lord Millet sat on the Board which heard this appeal. The advice of the Privy Council was delivered by Lord Hoffmann, who recognised, category one (business concepts) legislation (see 6.2.1.) in these terms:<sup>45</sup>

*“... in many (though by no means all) cases, the legislation will use terms such as income, loss and gain, which refer to concepts existing in a world of commercial reality, not constrained by precise legal analysis. ... 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.”*

In view of the highly artificial nature 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.

### **8.4. Dandelion Investments Ltd v CIR**

This case has been considered last because the approach is inconsistent with the above methodology. It provides a good example of the unprincipled approach to tax avoidance of “ I can’t explain why but I know it when I see it” that is reminiscent of Lord Templeman in Challenge.

In the High Court Tompkins J concluded that the respondent had not discharged the onus of proving the arrangement was not within the ITA 1976 equivalent to s BG 1. Tompkins J formulated the issues as follows:<sup>46</sup>

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<sup>45</sup> (2001) 20 NZTC 17,051, para. 10 at pg. 17,057.

<sup>46</sup> CIR Dandelion Investments Ltd (2001)20 NZTC 17,293, 17,307 para 83 (HC)



*“The real issue is whether one of the purposes or effects of the arrangement (not being a merely incidental purpose or effect) was tax avoidance. **This is not affected by some other provision in the Act that may make the interest payable deductible.**”* (Emphasis added)

Similar statements were made by McGrath J<sup>47</sup> in the course of delivering the judgment of the Court of Appeal. His Honour stated:

*“In reality there was no true business purpose to be achieved by the appellant in entering into the transaction other than to obtain the benefit of a deduction of an interest expense of \$570,080 by making a payment of that sum which was to be offset by a tax free dividend receipt of \$484,000. The transaction was circular in its inception and unwinding. Once unwound after the 12 months term of the loan it had no financial effects for the appellant, other than its net outlay of \$86,080 and, presumably a liability for the fees of its advisers. There was no risk to the appellant during that period. No element of business dealing other than tax avoidance can be identified as a purpose of the arrangement. It is an artifice involving a pretence and not a real group investment transaction at all. The concessional treatment of interest expenses under s 106(1)(h)(ii) ITA 1976 for borrowings to acquire shares in what would be a group company was not, on its true construction, intended to give the taxpayer the opportunity of obtaining a deduction in this way. It is the type of arrangement which s 99 was enacted to counteract in terms of the approach taken to the provision by the Privy Council in O’Neil at para 10 and by this Court in BNZ Investments Ltd at para 40. In those circumstances we agree with the High Court Judge that the purpose and effect of the composite arrangement was one of tax avoidance. The arrangement was accordingly void under s 99(2).”*

Were both courts correct in holding that the application of the equivalent provisions to section BG 1 was not affected by the equivalent to section DB 14(1)? This approach calls into question the correctness of the decision of the majority of the Privy Council in Challenge Corporation that was recently criticised by the Privy Council in O’Neil and Auckland Harbour Board. In reaching its conclusion, neither the High Court nor the Court of Appeal discussed the above cases that strongly suggest that approach of Privy Council in Challenge Corporation was conceptually incorrect. Section DB 14(1) governs the deductibility of interest in the context of a group of companies. It is difficult to escape the conclusion that this provision is designed to encourage a parent company to use borrowed finance to subscribe for equity in a group company. It is significant to note that there is no statutory requirement that either the group company or the parent company must demonstrate that the borrowed finance produced gross income for either member of the group. Clearly, this section contemplates that a subsidiary can be interposed between the parent company and the ultimate investment. In view of section CW 10 there can be no other interpretation than the analysis summarised above, because section CW 10 provides that certain inter company dividends pass free of tax. Accordingly, there could never be an explicit requirement in section DB 14(1) that the borrowed money must produce gross income given that section CW 10 exempts from tax the anticipated income flow associated with any downstream investment made by the group company.

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<sup>47</sup> Dandelion Investments Ltd (2003) 21 NZTC 18,010 at page 18,030 - 18,031.

It is difficult to escape the conclusion that what occurred in Dandelion and BNZ Investments was, in the words of Richardson P, a classic example of a structural choice. Sections CW 10 and DW 14(1) do not outline any criteria from which an underlying assumption as to the intended scope of those two provisions can be derived. Both sections clearly envisage a statutory mismatch, eg the derivation of an exempt dividend funded in part by an allowable interest deduction. Secondly, neither provision contains any statutory language which indicates that the ultimate derivation of gross income is an essential pre-requisite. This is hardly surprising given that there is always an element of commercial risk and a positive requirement that gross income must be produced would be inconsistent with the approach taken in cases such as *Grieve*,<sup>48</sup> *Pacific Rendezvous*<sup>49</sup> and *Brierley*.<sup>50</sup> Thirdly, it should be noted that subparas (i) and (ii) of section DB 8 both contain a statutory requirement that the borrowed money and interest must produce gross income, whereas there is obviously no such similar requirement in section DB 14(1).

### 8.5. Dandelion Investments Revisited

It would appear that McGrath J was concerned about the absence any “real investment” financed from the borrowed money.<sup>51</sup> Throughout his judgment, his Honour stresses the mismatch between the deductible interest and the non assessable dividend and the fact that the tax saving associated with the interest deduction converted a cash loss into an after tax net gain. His Honour also stresses the fact that the subsidiary company which was used to acquire the UK target company was an empty shell. The case raises a numbers of questions including how would his Honour have approached the question of the application of s BG 1 if the facts had been slightly different? For example, it is not difficult to envisage a scenario where the borrowed money is used to fund a real investment.

The following diagram illustrates how it is conceptually possible for a New Zealand company to incorporate two Cook Island subsidiaries.

< INSERT DIAGRAM 8 HERE >

The first Cook Island subsidiary would be funded fully with equity capital from the parent (2). That equity capital would be financed by the first loan borrowed from a New Zealand bank (1). An interest deduction would be available because the borrowed funds were used to subscribe for capital in the first Cook Island company. The proceeds of the share issue would be used by the first Cook Island company to lend the money to the second Cook Islands company (3). That company would then on-lend the funds back to the New Zealand bank (4). However, the loan would be deposited with the offshore branch of the New Zealand bank. The offshore branch would use the loan to make a second loan to the taxpayer (5), who used the proceeds to fund a real investment (6).

How would McGrath J react to this hypothetical structure? Would his Honour allow an interest deduction and if so, how much would be allowed? Presumably his Honour would allow the second interest deduction because the funds can be traced to the

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<sup>48</sup>*Grieve v CIR* (1983) 6 NZTC 61,682 (CA).

<sup>49</sup>*Pacific Rendezvous Ltd v CIR* (1986) 8 NZTC 5,146 (CA).

<sup>50</sup>*CIR v Brierley* (1990) 12 NZTC 7,184 (CA).

<sup>51</sup>*CIR v BNZ Investments Ltd* (2001) 20 NZTC 17,103 (CA).

real investment, and therefore the criteria of section DB 14(1) are satisfied. But what about the first loan? Once again any attempt to disallow that deduction would be based on a reading into section DB 14(1) (via s BG 1), of an additional criteria that is simply not apparent from the statutory test. Would it make any difference if the taxpayer could demonstrate that but for the double deduction and the positive impact it had on the cost of funds, the investment would not have proceeded. In other words, the investment is not financially viable at an implicit interest rate of 10 percent whereas it could only be undertaken at an effective interest rate of 0.004 percent. Lord Hoffmann's observation in *MacNiven* seems applicable.<sup>52</sup>

*"But when the statutory provisions do not contain words like 'avoidance' or 'mitigation' I do think that it helps to introduce them. The fact that steps taken for the avoidance of tax are acceptable or unacceptable is the conclusion at which one arrives by applying the statutory language to the facts of the case. It is not a test for deciding whether it applies or not."*

In view of the consistent approach taken in *Challenge*, *BNZ Investments*, *Auckland Harbour Board*, *O Neil*, and finally *Peterson*, this decision should be seen as an abbreviation.

## **8.6. Additional Statutory Examples**

### **8.6.1. Loss Offset Rules**

Subparts IF and IG of the ITA deal with the situation where profits and losses can be offset between group companies.<sup>53</sup> The purpose or effect of any offset arrangement is solely 'tax avoidance' as the offset eliminates the taxable income of the profit company and reduces the available losses of the loss company. The arrangement between the two group companies cannot be subject to Section BG 1 of the ITA because the loss carried forward and offset rules specifically contemplated this type of activity and they do not correspond to the ordinary commercial principles contained in the Companies Act 1993, which generally speaking is to treat the loss company and the profit company as two separate independent legal entities.<sup>54</sup>

### **8.6.2. Deductibility Of Interest**

There is a specific unusual provision in the ITA that enables a company which borrows money to subscribe for shares in a 100% owned subsidiary to obtain an interest deduction.<sup>55</sup> If the subsidiary used the proceeds of the share issue to its parent company to invest in a foreign company listed in a 'grey list' country, then the dividend derived from the offshore investment would be free of New Zealand tax. The effect of the arrangement is clearly to create a tax mismatch, i.e. an interest deduction with the corresponding income constituting a tax-free receipt. Clearly the purpose or effect of the 'arrangement' is to avoid tax, but the outcome is specifically recognised by a combination of two specific provisions which are both category two

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<sup>52</sup> *Westmoreland Investments Ltd v MacNiven* [2001] 1 All ER 865, 884, para 62 (HL).

<sup>53</sup> A company can only carry a loss forward into a subsequent income year if it had maintained 49% continuity of shareholding from the beginning of the year of loss to the end of the year of carry forward. A company can only offset a loss carried forward if there is at least 66% commonality of shareholding between the loss company and the profit company during that period.

<sup>54</sup> Grouping is allowed to enable the preparation of consolidated accounts.

<sup>55</sup> Refer to Sec. DB 8 of the ITA for further details.

legislative (see 6.2.2) provisions. This was one of the provisions which the taxpayer in BNZ Investments Ltd. took advantage of. The other was the inter-company dividend exemption, which is another example of category two legislation.

### 8.6.3. LAQC

If a company purchases a rental property and elects to become a LAQC, the shareholders of the company are able to offset any losses incurred by the company against their other sources of income. If the same property were instead owned by a non-LAQC, the losses would be locked up in the company and could not be allocated to the shareholders. Once again the purpose or effect of structuring an investment via a LAQC is tax avoidance but this type of legislation is a good example of the category two. The offsetting of the losses is specifically contemplated by the specific regime within the ITA.

## **9. COMMENTS ON THE IRD EXPOSURE DRAFT INA 0009 INTERPRETATION OF SECTION BG 1 OF THE ITA**

### **9.1. Introduction**

In September 2004, the IRD issued the above exposure draft<sup>56</sup> which outlines the CIR's approach to the application of Section BG 1 of the ITA. The exposure draft is designed to provide an overview of the general principles which the CIR believes are applicable rather than providing taxpayers with a comprehensive analysis. It will eventually replace the CIR's 1990 statement on tax avoidance.

### **9.2. Summary Of The CIR's Approach**

The IRD proposed to reconcile of the objectives of Section BG 1 of the ITA and other provisions of the ITA by following a six-step process, as follows:

- 1) *Determine if there is a tax avoidance arrangement and if so, its scope.*
- 2) *Does the arrangement involve "tax avoidance" as defined in the ITA?*

The combined effect of the three limbs of the definition of "tax avoidance" is that the taxpayer must do one of the following:

- Directly or indirectly alter the economic incidence of tax;
- Defeat or avoid liability to pay income tax;
- Reduce or minimise liability to income tax; and
- Defer a liability to income tax to a later date.

- 3) *Is there a purpose or effect of tax avoidance?*

To ascertain whether the arrangement has a purpose or effect of tax avoidance, the arrangement is examined to determine whether it can be "predicated" that the arrangement was implemented in the particular way so as to avoid tax.<sup>57</sup> It is no longer an automatic defence to claim that the arrangement is capable of explanation by referring to ordinary business or family dealing.

- 4) *Determining if a purpose or effect is more than merely incidental.*

A "merely incidental" purpose or effect is outside the ambit of Section BG 1 of the ITA. A merely incidental purpose or effect is something that follows from or is

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<sup>56</sup> NZIRD: Public Rulings Unit Adjudication and Rulings, "BG 1 and GB1 of the Income Tax Act 2004: Exposure Draft for External Consultation Reference INA 0009", [www.taxpolicy.ird.govt.nz](http://www.taxpolicy.ird.govt.nz)

<sup>57</sup> The origin of this approach was the Privy Council judgement in *Newton v C of T* (1957) 96 CLR 665.

necessarily linked to some other non-tax purpose or effect without any contrivance or artificiality.

5) *Does the arrangement frustrate Parliament's intention for the particular provision, regime or the ITA as a whole?*

The CIR considers that the approach to be adopted in applying Section BG 1 of the ITA is to first ascertain whether the section applies on its terms, and then whether the arrangement would frustrate rather than facilitate Parliament's intention for the provision, regime or the ITA as a whole.

6) *Adjustment to the tax position under Section BG 1 of the ITA*

The statutory power of reconstruction will be exercised to ensure that any adjustments counteract the tax advantage obtained by the taxpayer from the void arrangement. The power of adjustment/reconstruction is limited to a party to the arrangement, and all persons affected (who are not necessarily a party) by the arrangement.

### **9.3. The Concept Of An Arrangement: Is A Meeting Of The Minds Necessary?**

The exposure draft reflects the law prior to the decision of the Privy Council in the Peterson case. The CIR's interpretation is based on the decision of the majority of the Court of Appeal in BNZ Investments Ltd. However the majority and minority in Peterson held that the statutory definition of "arrangement" did not require any element of consensus or a meeting of the minds. It is sufficient if the taxpayer is a party affected by the arrangement. The exposure draft will require modification to reflect the approach taken by the Privy Council in Peterson.

### **9.4. The Three Categories Of Legislation**

A major criticism of the approach outlined above (i.e. does the arrangement frustrate Parliament's intention for the particular provision, regime or the ITA as a whole) is the IRD view on taxpayers who enter into arrangements which are designed to exploit pure creations of the ITA? In other words, those concepts that have no independent reality under the ordinary commercial law but only exist in relation to income tax. Invariably there is no independent external yardstick in relation to the concept. This working paper has referred to the example of a LAQC, which is a tax creation that only exists for income tax purposes. A LAQC provides taxpayers with the ability to pass through tax losses in a manner akin to a partnership but a LAQC provides the shareholders<sup>58</sup> with limited liability. Clearly there is no external yardstick because there is no such entity recognised under the Companies Act 1993 or the Partnership Act 1908. Other examples include the ability of closely related companies to group and offset losses for income tax purposes. Once again this is inconsistent with the fundamental structure of the Companies Act 1993, which does not contain any comparable regime.

This issue was first discussed in Challenge Corporation Ltd., and more recently by the Privy Council in O'Neil, and Auckland Harbour Board. The approach of both the majority and minority in Peterson is consistent with these earlier decisions. A major deficiency in the exposure draft is its omission of a discussion about whether the CIR contends Section BG 1 of the ITA could apply in these sorts of circumstances.

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<sup>58</sup> Which for tax purposes cannot exceed more than five.

## 9.5. Perceived Deficiencies In The Legislation

The following two quotations taken from the exposure draft clearly indicate that the CIR has not understood the importance of the judgments of the Privy Council in Auckland Harbour Board and Peterson. This is a serious deficiency because neither of those two decisions support the broad proposition that Section BG 1 of the ITA can be used to attack schemes that the CIR believes are contrary to his perception of how Parliament intended the legislation under consideration to be applied. The claims are that:

*Accordingly, when considering whether section BG 1 is to be applied to an arrangement it is important to identify Parliament's intention. Is the legislative purpose satisfied by permitting the arrangement to be effective from a taxation point of view? Put another way, does the arrangement facilitate the statutory purpose and therefore meet Parliament's intention, or alternatively, does the arrangement frustrate the statutory purpose of a provision, a regime or the Act as a whole?.*<sup>59</sup>

*In the Commissioner's opinion, the relevant enquiry in the anti-avoidance context is whether Parliament intended the specific provision, regime or the Act as a whole to apply to the arrangement unhindered by the general anti-avoidance provision. In other words, in an anti-avoidance context the goal is to discover the underlying legislative intention of the relevant operative provision, regime or the Act, and then to consider whether Parliament intended to legislate to apply in the way contended for by the taxpayer, or whether to do so would amount to frustrating Parliament's intention. This view is consistent with the Privy Council's analysis in O'Neil*<sup>60</sup>

It maybe consistent with what was said in O'Neil but is not consistent with the other two decisions of the Privy Council which specifically rejected this approach to the application of Section BG 1 of the ITA. It is not a provision that is designed to confer extra statutory powers on the CIR to amend the ITA in a manner that he thinks is in accordance with his perception of Parliament's intention.

## 9.6. What About Auckland Harbour Board And Peterson?

The CIR's assertion in the exposure draft that Section BG 1 of the ITA is intended to fill in legislative gaps or short comings is completely contrary to the decision of the Privy Council in Auckland Harbour Board. The fact that Parliament subsequently passed legislation to deem all gifts of financial arrangements to be disposed of for market value clearly indicates that Parliament never intended the taxpayer to obtain the tax advantages upheld by the Privy Council in this case. Secondly, the Privy Council were aware of the amending legislation yet that did not deter them from resiling from the interpretative approach they developed for Section BG 1 of the ITA. The judgment discussed above is a strong rejection of the CIR's assertion that Section BG 1 of the ITA operates to fill in the CIR's perceived legislative gaps.

The passage from the judgment of Lord Hoffmann is completely contrary to the interpretation contended by the CIR. He said<sup>61</sup> that the only way to inquire into the

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<sup>59</sup> Para. 4.5.6. at pg. 61.

<sup>60</sup> Para. 4.5.7 at pg. 62.

<sup>61</sup> In Auckland harbour Board(2001) 20 NZTC 17,008, Paras.2,4,5,6, 8, 9, and 11 at pgs. 17,09 to17,112.

so-called intention of Parliament is through the language expressed by Parliament. In Auckland Harbour Board, the Privy Council did not think it was possible to read the relevant legislation as requiring anything other than the actual consideration to be adopted. Clearly Parliament's intention was frustrated because the amending legislation now prevents a deduction when a financial arrangement is transferred for less than its market value. If the CIR's assertion was correct, then the Privy Council would have supported his application of Section BG 1 of the ITA. To have done so would have meant exposing taxpayers to the imposition of a liability according to the exercise of administrative discretions instead of the law enacted by Parliament.

#### **9.7. A More Balanced Interpretation Of O'Neil**

The decision of the Privy Council in O'Neil does not assist the CIR because that case involved a category 1 legislation, which covers the fundamental concepts and principles of the assessable income and allowable deductions. Secondly, the approach in O'Neil is consistent with Auckland Harbour Board. In O'Neil, Lord Hoffmann summarised the role of Section BG 1 of the ITA and its potential application to category 1, category 2, and category 3 legislation. The Privy Council clearly saw the issue before the court as a classic case of statutory interpretation, which revolves around the words used by Parliament. There is no room for any speculation about what Parliament may or may not have intended.

#### **9.8. Is There A Coherent Legislative Scheme Reflected In The ITA?**

The answer to this question is clearly no. The CIR's approach to the application of Section BG 1 of the ITA is based on a fallacy. In many cases the policy of a specific provision or a regime, or indeed the ITA, is difficult to discern because there is no coherent policy. This will be inevitably the case where multiple taxation regimes apply to a series of often complex, commercial transactions. The clearest example of this difficulty is the Peterson case which involved the application of the core provisions which governed deductions, specific features of the depreciation regime, the taxation of special partnership's, the taxation of film investments, the absence of an international tax regime which could have applied to the offshore transactions, etc. Clearly, Parliament did not at the time the various provisions were enacted consider the implications of how the various regimes were intended to interact in the case of a film investment.

This problem was highlighted by Richardson J. in Challenge Corporation Ltd. when he noted that the ITA reflects historical compromises between political parties and coalition governments. The ITA contains the drafting styles of many different Parliamentary counsels who make annual amendments. The CIR's approach incorrectly assumes there is a totally coherent scheme, which follows a completely consistent pattern. The clearest examples of the contrary approach is the absence of a comprehensive capital gains tax but the presence in the ITA, of a random series of specific amendments which were inserted by various political parties who have occupied the Treasury benches from time to time. The same is true of the specific regimes dealing with the taxation of business entities which do not reflect a coherent approach to this complex topic. It is unrealistic to assume that all the tax objectives are readily discernible.

The danger to taxpayers of the view expressed in 9.4 is the assertion that Section BG 1 of the ITA is designed to confer on the CIR, a power to effectively fill in any perceived gaps in the legislation whenever the policy is ambiguous or perhaps difficult to discern. That assertion was rejected by the Privy Council in Auckland Harbour Board in clear unmistakable terms. The cases cited by the CIR do not support his interpretation that Parliament via the enactment of Section BG 1 of the ITA conferred on him a power to amend the law for, in the words of Lord Hoffmann, that "... would amount to the imposition of tax by administrative discretion instead of by [Parliament]".

## **10. ANALYSIS OF THE JUDGEMENT IN ACCENT MANAGEMENT LTD V CIR**

### **10.1. An Inconsistent Approach**

This decision has been left to end of the working paper because it is inconsistent with all of the preceding analysis and in particular the scheme and purpose approach which is the conceptual basis of my analysis. Venning J applied Section BG 1 of the ITA on the grounds that the tax advantages associated with the fixed licence premium and the insurance policy meant that the tax advantages were more than incidental. He said<sup>62</sup>:

*"The plaintiff investors are experienced and astute commercial business people. They may have had a general interest in investing in forestry, perhaps even in a Douglas fir plantation. However, the reason they invested in this particular investment, the Trinity scheme, was the tax benefits associated with the scheme. Without the tax benefits of the Trinity scheme it was less attractive than other investments. As experienced business people they would have been well aware of that fact, and other opportunities available to them."*

The same could be said about the tax driven structure in BNZ Investments Ltd. which was deliberately designed to appeal to tax loss companies and only worked because of the statutory mismatch summarised above. The tax-induced features were clearly more than incidental. They shaped the relationships between all of the parties. Similar comments can be made about the structure in Auckland Harbour Board which packaged together the tax attributes of a charitable trust and the favourable tax consequences of gifting a financial arrangement to a related party. Clearly none of dealings were at arms length and the tax consequences could hardly be seen as incidental to the pursuit of valid commercial dealings.

### **10.2. Analysis Of The Judgement In Accent Management Ltd v CIR**

The judgement was written before the decision of the Privy Council in Peterson and the approach taken by Venning J. is inconsistent with both the majority and minority judgements in Peterson. It is also inconsistent with the earlier Privy Council decisions in Auckland Harbour Board and O'Neil. For following reasons it is unlikely that the Court of Appeal will support the decision of the High Court.

#### **10.2.1. Transactions can incorporate a degree of tax relief**

The New Zealand courts have consistently recognised that transactions can be accompanied by a degree of tax relief without being caught by Section BG 1 of the ITA. The courts have consistently confirmed that if a genuine business transaction

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<sup>62</sup> Para. 321 at pg. 19,077.



can be implemented in two different ways, with one involving a lesser tax liability than the other, then Section BG 1 of the ITA should not automatically apply because the taxpayer chose the most efficient alternative. For example, Woodhouse P. said in Challenge:<sup>63</sup>

*“Many taxpayers when considering a course of action are likely to appreciate and welcome an opportunity provided by the Act for achieving some tax benefit as an aspect of it. But this should not bring the transaction automatically within the avoidance provisions of section [BG 1]. By itself conscious recognition and acceptance that a commercial transaction will be accompanied by a degree of tax relief is not the issue.”* [Emphasis added]

Venning J did not refer to this principle and therefore, it is difficult to assess what features of the case took it outside the scope of Woodhouse P reminder.

Throughout his judgment, Venning J made much of the fact that there was considerable financial uncertainty surrounding the viability of the forest, which depended on a number of assumptions that tried to estimate a number of uncertainties associated with the harvesting of the forest in 50 years time. For example, what was the likely market price for the timber? He said:<sup>64</sup>

*“... the uncertainty of the profitability of the forest venture is in stark contrast to the certainty and extent of the deductions and consequent tax advantages the scheme provided the plaintiffs as investors.”*

There were a number of aspects of the structure and documentation which were designed to maximise the available tax deductions. However, the same can be said of the investment structure that was used in Peterson. For example, the investors in Peterson used a special partnership structure, which for tax purposes, was a pass-through entity that allowed the available tax losses to flow into the hands of the investors. Secondly, a special partnership provided limited liability. Thirdly, one of the two films was never released. There is no suggestion in Trinity that the future price of timber, in 50 years time, could mean that the forests may never be harvested.

In the Accent Management Ltd case, the taxpayers entered into the venture via loss LAQC'S and the limit on the number of shareholders was effectively overcome via adopting a partnership and a joint venture arrangement.

The structure in BNZ Investments Ltd. provided all of the participants with clearly identifiable tax advantages which had they not been available could well have jeopardised the underlying lending arrangements.

#### *10.2.2. The Future Valuation of the Forest and the Fixed License Premium*

Venning J devoted a significant amount of his judgment to an analysis of the various net present value calculations provided by the taxpayers and the CIR. The various assumptions as to the underlying rate of inflation, real price growth, market demand, and yields were used to demonstrate whether the standard discounted cash flow techniques would produce a negative or positive net present value calculation based on various assumptions. His Honour's conclusion was that:

*“... using the methodology suggested by Professor Teece ... and taking the stumpage rate, log price growth and inflation at the most favourable extent of the*

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<sup>63</sup> (1986) 8 NZTC 5,001, col. 2 at pg. 5,006.

<sup>64</sup> Para. 310 at pg 19,075.

*ranges I have found after considering the expert evidence the forestry investment will not return a positive net present value. On that analysis of forestry investment Trinity will not be a successful investment.”*

This finding was used as the platform for invoking Section BG 1 of the ITA. This approach is fundamentally flawed for the following reasons:

The Court was considering the application of Section BG 1 of the ITA to the general deduction provision, which is Sec. BD 2 of the ITA. Sec. BD 2 of the ITA allows a taxpayer to claim a deduction for expenditure necessarily incurred in carrying on a business. The CIR accepted that all of the expenditure satisfied that test which should have been the end of the matter. It is well established that it is not for the CIR to seek to impose his own views as to how a business should be carried on by a taxpayer. This principle was established in *Commissioner of Inland Revenue v Europa Oil (NZ) Limited*<sup>65</sup>. The fact that the CIR might have paid more, or less, for a particular good or service is not a relevant consideration. Secondly, the point that the CIR might have required a valuation as a precondition to agreeing to make an expenditure is of no real moment. The question is not whether the CIR would have incurred an expenditure at the level, or on the terms and conditions, agreed by the taxpayer, but whether in making that expenditure, the taxpayer satisfied the relevant tests of deductibility within the ITA. The capacity for a taxpayer to satisfy those criteria, and in particular, the criterion that the expenditure in question was incurred in the carrying on of a business for the production of gross income, recognizes the scope for different commercial judgments. Furthermore, in *Grieve v CIR (1984) 6 NZTC 61, 682*, for example, the Court of Appeal was required to determine whether as a precondition to the availability of a deduction pursuant to the then equivalent of Sec. BD 2 of the ITA, a taxpayer must have had a reasonable expectation of making a profit. That proposition was rejected by the Court of Appeal. In the present context of valuation, the following useful general observation was made:

“Businesses do not cease to be businesses because they are carried on idiosyncratically or inefficiently or unprofitably or because the taxpayer derives personal satisfaction from the venture” (at page 61,691).”;

The second point is that the term “valuation” suggests a range of market prices. This is especially true in ‘green fields’ investments, where the experts will differ over the appropriateness of discounted cash flows, and historical cost plus estimated future costs;

A valuation is only an issue if the investor is fully at risk. Where there is for example a limited recourse loan and the repayment is limited to future cash flow the importance of valuation is reduced. In the Trinity case, the insurance policy was similar in effect to a limited recourse loan; and

There is no general provision in the ITA for the CIR to reconfigure prices that have been agreed upon after arms’ length bargaining.

The legislative solution known as the ‘preferred deduction rule’ does not contain any statutory powers that authorises the CIR to challenge the validity of the price fixed in arms length negotiations.

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<sup>65</sup> (1971) NZLR 641 at pg. 649; (1976) 2 NZTC 61,066 at pg. 61,075.

### 10.2.3. *Category 2 Legislation*

The tax advantage gained by the investors is conceptually similar to the advantages associated with the Auckland Harbour Board structure and the arrangements that were entered into in the BNZ Investments Ltd. decision. The taxpayers in Trinity deliberately structured the investment to take account of a number of unique tax concepts that are contained in the ITA and only exist for tax purposes. For example, the ITA permits taxpayers to claim current year deductions associated with the planting and maintenance of a forest even though the relevant income will not be derived until (in the case of Douglas fir 50 years) later. Secondly, the LAQC regime allows taxpayers to obtain the benefit of limited liability and to directly access the tax losses associated with the underlying commercial activity. It is difficult to accept the correctness of Venning J's approach to Section BG 1 of the ITA in view of the highly artificial nature of what occurred in Auckland Harbour Board. Secondly, the structure was conceptually similar to Peterson and BNZ Investments Ltd. in that, it was deliberately designed to take advantage of a number of unrelated tax preferences, which were linked together into a tax efficient structure that invested in a genuine commercial activity, i.e. forestry.

## 11. **CONCLUSIONS**

The decision of the Privy Council in Peterson will be of interest to all readers in jurisdictions where there is a general anti-avoidance provision which had been deliberately drafted in very wide terms and if applied literally, could undermine other features of the country's tax system. The Peterson case supports an approach that has been successfully developed by the New Zealand courts and focuses on the different categories of legislation which make up most tax systems. This approach was first developed by Richardson J in Challenge Corporation Ltd. in 1986 and adopted by the Privy Council in Auckland Harbour Board, and in O' Neil. The only inconsistent decision is Dandelion Investments which can be viewed as a judicial aberration.

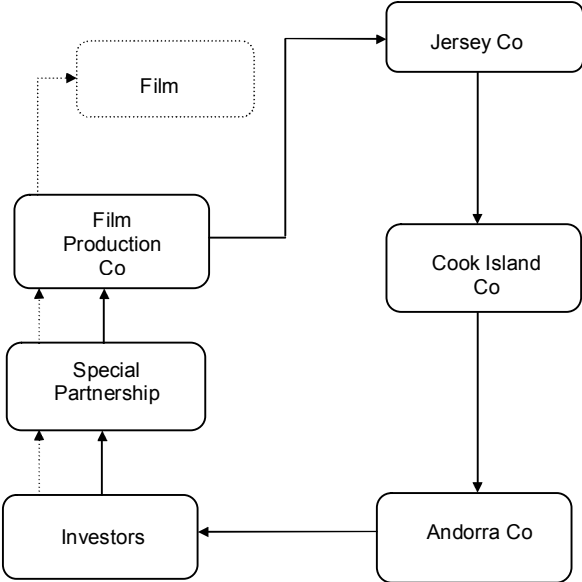
The Peterson decision is important because it has reconfirmed this interpretative technique, which forms the conceptual basis of the CIR's 2004 draft policy statement on the application of Section BG 1 of the ITA.

David Dunbar

12 December 2005

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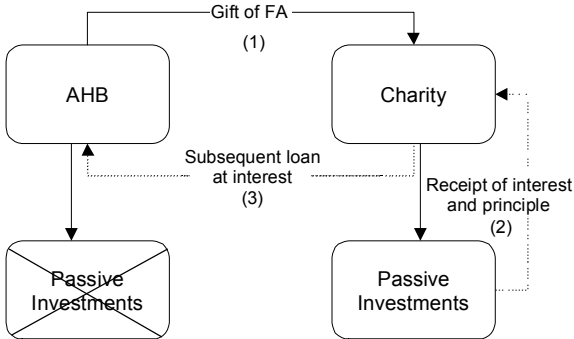
DIAGRAM 1



Circular flow of funds associated with the limited recourse loan:  $\longrightarrow$  : \$Y = 56% of total funds.

real cash  $\dashrightarrow$  : \$X = 44% of total funds.

DIAGRAM 2



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DIAGRAM 3

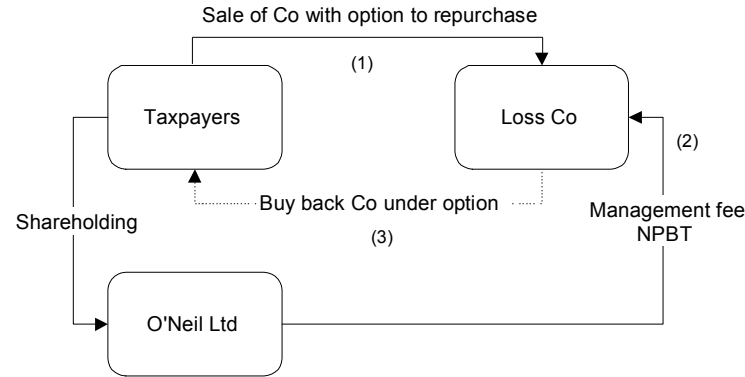
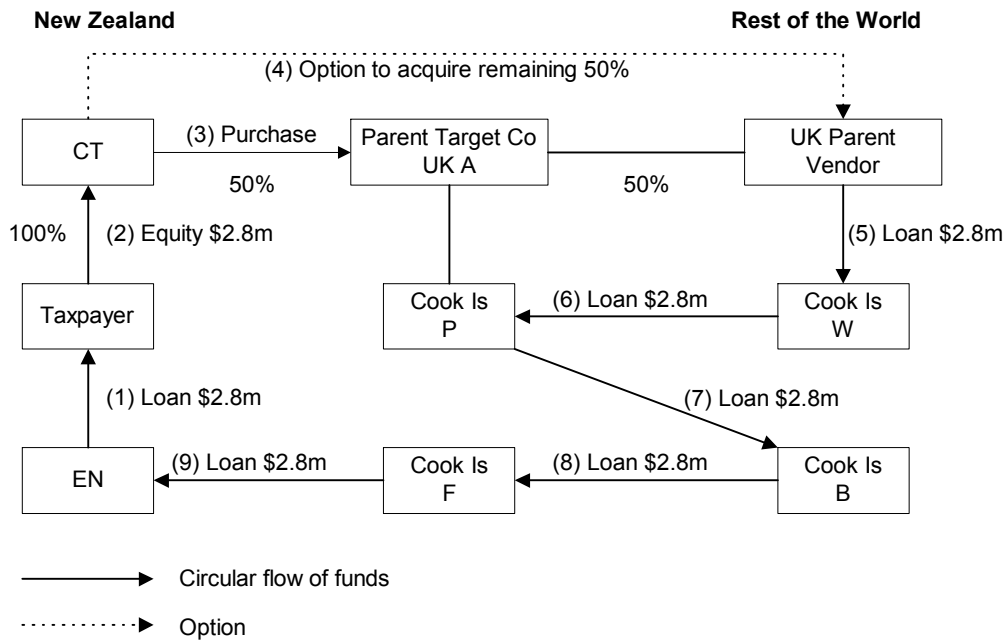
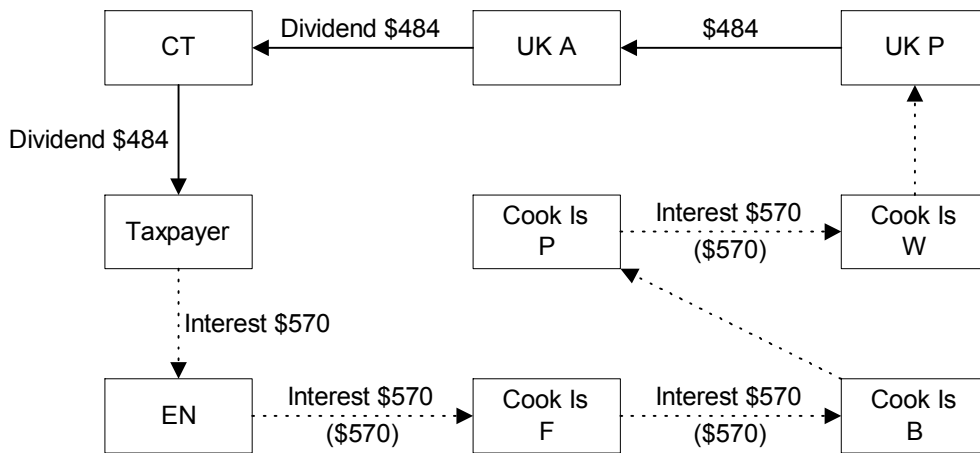


DIAGRAM 4: The investments



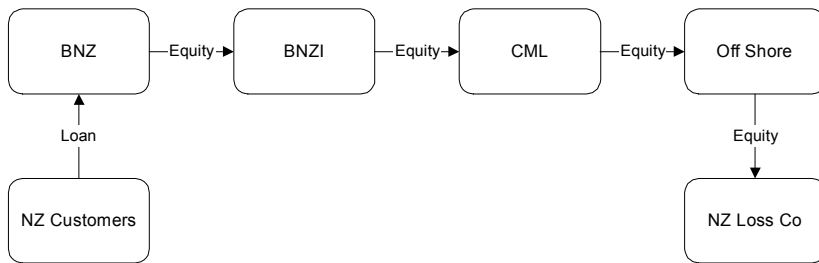
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DIAGRAM 5: The tax mismatch



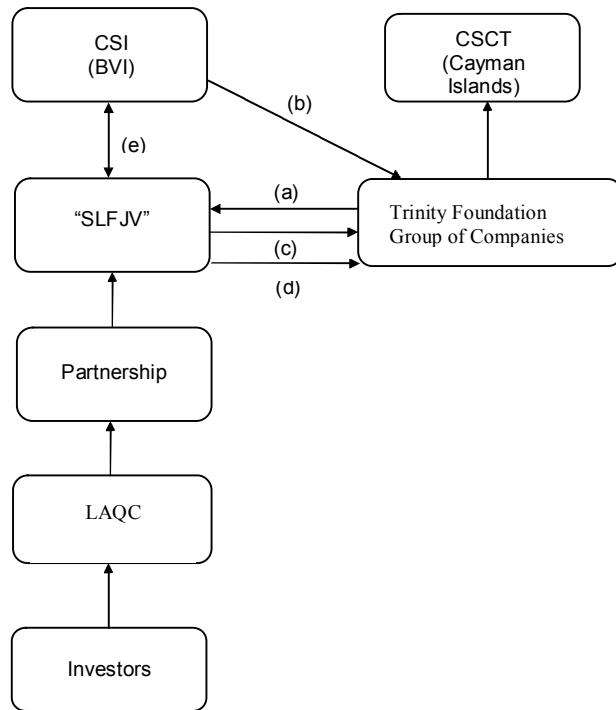
Dividend	484
Interest	<u>(570)</u>
Cash loss	86
Tax benefit 48%	<u>274</u>
<b>Net benefit</b>	<b><u>188</u></b>

DIAGRAM 6



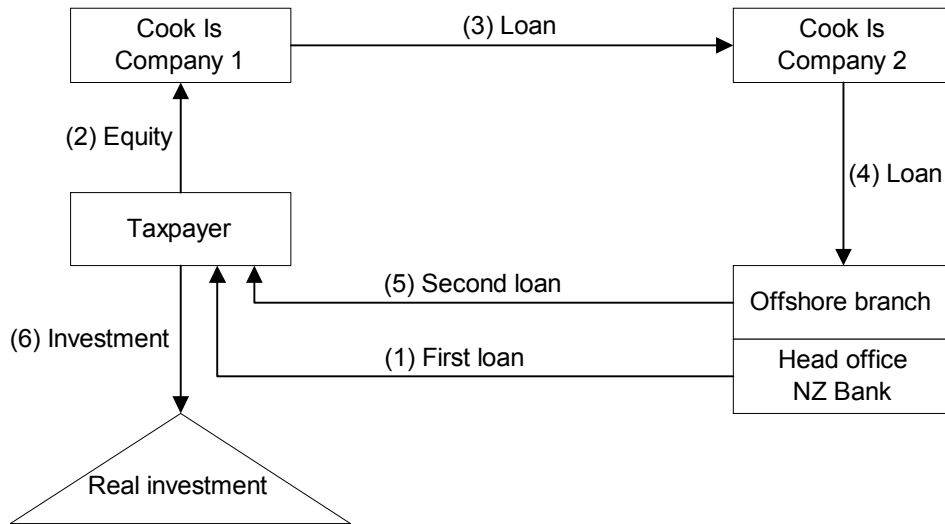
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DIAGRAM 7



- (a) Licence to plant and harvest Douglas fir forest for 50 years.
- (b) Insurance policies.
- (c) Promissory notes/debentures.
- (d) Annual licence fee/deferred licence premium.
- (e) Initial and deferred insurance premium

DIAGRAM 8: A Double Deduction



Assuming the taxpayer (1) borrowed \$100,000 @ 10 percent, (2) receives a dividend from the first Cook Islands Company equivalent to the interest on the first loan, and (3) is subject to a tax rate of 48 percent (the rate applicable in 1984), the net result of the scheme from the taxpayer's viewpoint is:

Interest paid on first loan	\$10,000
Interest paid on second loan	<u>\$10,000</u>
Total tax deduction	(\$20,000)
Less tax at 48%	<u>\$(9,600)</u>
After tax interest cost	\$10,400
Less inter-company dividend (exempt)	<u>(\$10,000)</u>
Net borrowing cost	<b>\$400</b>
Effective tax rate	0.004%

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