

Tax update

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discuss tax avoidance

SCHEME AND PURPOSE IN TAX AVOIDANCE

On 24 September the Commissioner released a draft interpretation statement on the general anti-avoidance provisions in the Income Tax Act 1994 ("the Act") (*Interpretation of Sections BG 1 and GB 1 of the Income Tax Act 2004* (INA0009)).

Section BG 1 provides that a tax avoidance arrangement is void as against the Commissioner for tax purposes. Where an arrangement is so void, the Commissioner may counteract a tax advantage obtained from or under the arrangement, in accordance with the "reconstruction" provisions in Part G of the Act, and in particular s GB 1.

"Tax avoidance arrangement" is defined as an arrangement that directly or indirectly:

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

"Tax avoidance" is in turn defined as including:

- directly or indirectly altering the incidence of any income tax;
- directly or indirectly relieving any person from liability to pay income tax; or
- directly or indirectly avoiding, reducing, or postponing any liability to income tax.

By their nature, tax avoidance arrangements are arrangements that comply in all respects with the specific requirements of particular regimes in the Act, but are nonetheless objectionable and should therefore be void against the Commissioner. Where an arrangement fails to comply with the specific requirements of the particular regime being relied upon, there is no need for the Commissioner to call in aid the anti-avoidance provisions.

It has long been recognised that a literal application of s BG 1 and the definitions of "tax avoidance arrangement" and "tax avoidance" would render void against the Commissioner a myriad of ordinary transactions and arrangements which take advantage of specific tax incentives or concessions afforded by the Act. As McGechan J observed in *BNZ Investments Ltd v CIR* (2000) 19 NZTC 15,372 (in relation to what was then s 99 of the Income Tax Act 1976):

[104] Returns on the prime Bank investments involved would not be sufficient unless New Zealand tax advantages were obtained. This situation could hardly be stronger. A tax avoidance purpose existed, and was not merely incidental. To the contrary, it was integral...

That, however, does not in itself resolve [the submission to the effect that the deductions were allowed by the

scheme of the Act] ... more is necessary. There remains the difficulty of reconciling [the broad provisions of what was then s 99(2) of the Act] with the permissive specifics of other provisions in the Act.

One of the starkest examples of a situation in which a literal application of the provision would have absurd results is that of a "subvention" payment. Where one company in a group has net income and another has a net loss, the Act permits the profit company to make a subvention payment to the loss company. The subvention payment is deductible to the profit company and reduces (or eliminates) its net income and tax payable. The subvention payment is income of the loss company, but this company is able to offset its net loss against the payment, so that no tax is payable. Such a transaction is generally purely tax motivated. It has the effect of directly or indirectly reducing a liability (of the profitable company) to income tax. Often it will have no commercial purpose, or at least no such purpose that could not have been achieved by other means. On a literal construction, s BG 1 applies. Nevertheless, the Act deliberately permits subvention payments. Therefore, the application of s BG 1 would be an absurdity.

There is thus a clear need to "read down" s BG 1. As with any question of statutory interpretation, the Interpretation Act 1999 and its predecessor, the Acts Interpretation Act 1924, are central. Section 5(1) of the 1999 Act provides that "the meaning of an enactment must be ascertained from its text in light of its purpose". This is regarded as a plainer and more economical re-enactment of s 5(j) of the 1924 Act, which provided that "every Act ... shall receive such fair, large, and liberal construction and interpretation as will best ensure the obtainment of the object of the Act and of such provision or enactment according to its true intent, meaning, and spirit".

Sir Ivor Richardson referred to s 5(j) of the 1924 Act in what has come to be regarded as a seminal judgment on the question of the scope of application of s BG 1, and reconciling the provision with "permissive specifics" of the Act, in *CIR v Challenge Corporation Ltd* (1986) 8 NZTC 5,001. There, His Honour held (at 5,020):

Section 99 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 s 99 under the Statute and of the relation between them. That is a matter of statutory construction and the twin pillars on which the approach to Statutes mandated by section 5(j) of the Acts Interpretation Act 1924 rests are the scheme of the legislation and the relevant objectives of the legislation. Consideration of the scheme of the legislation requires a careful reading in its historical

context of the whole Statute, analysing its structure and examining the relationships between the various provisions and recognising any discernible themes and patterns and underlying policy considerations.

Next to the so-called tax avoidance/tax mitigation dichotomy promulgated by Lord Templeman in *Challenge Corporation v CIR* [1986] 2 NZLR 555 (PC), this approach has been the most influential development in judicial thinking in this area in New Zealand in the past 20 years. Moreover, following *O'Neil v CIR* (2000) 20 NZTC 17,051 (PC), the scheme and purpose approach is now pre-eminent. Delivering the unanimous advice of Their Lordships, Lord Hoffman described the tax avoidance/tax mitigation dichotomy as "unhelpful" (it has also been rejected as a theoretical basis for the "fiscal nullity" doctrine by the House of Lords — see *MacNiven v Westmoreland Investments Ltd* [2001] 2 WLR 377) and went on to endorse the scheme and purpose approach, where he said:

[10] ... Their Lordships consider this to be a paradigm of the kind of arrangement which s 99 was intended to counteract. On the other hand, the adoption of a course of action which avoids tax should not fall within s 99 if the legislation, upon its true construction, was intended to give the taxpayer the choice of avoiding it in that way.

Lord Hoffman's use of the word "choice" is significant. Proper statutory interpretation underpins the so-called "choice principle", which holds that s BG 1 should not deprive taxpayers of concessions or structural incentives contained in the Act if, upon its true construction, the Act is intended to afford these concessions or structural incentives in the relevant circumstances. The scheme and purpose approach and the choice principle are really different names for the same method of statutory construction.

In *Tax Information Bulletin* Vol 1, No 8 February 1990, the Commissioner published a policy statement on the application of s 99, in which he said:

The Commissioner's approach requires a careful and thorough analysis of —

- (a) the underlying scheme and purpose of the Act as a whole and of the specific provision under review;
- (b) the arrangement to ascertain its purpose or effect;
- (c) whether a fair and reasonable inference can be drawn that tax avoidance is one purpose of the arrangement (other than merely incidental);
- (d) whether following this analysis it can be inferred that the arrangement frustrates the underlying scheme and purpose of the legislation.

This statement is generally read as affording primacy to an analysis of the underlying scheme and purpose of the Act as a whole and of the specific provision under review. This analysis bears on the very question whether the arrangement has a purpose or effect of tax avoidance.

The *Interpretation Statement* takes a slightly different approach. While an analysis of scheme and purpose remains an important "reconciling" factor, it appears to be viewed as being somewhat less fundamental than in the 1990 bulletin or indeed by Sir Ivor and the Courts more generally. Having discussed in some depth the definitions of "arrangement" and "tax avoidance" and the meaning of "more than merely incidental", the *Interpretation Statement* goes on to deal with

what it describes as "judicial approaches applicable to section BG 1".

4.1.1 Even if section BG 1 potentially applies, because the arrangement may have a more than merely incidental purpose or effect of tax avoidance, a question arises about whether its application is intended by Parliament. There is inevitably a tension between the different and possibly conflicting objectives of specific legislative provisions and the general anti-avoidance provisions (sections BG 1 and GB 1 of the Income Tax Act).

Later the *Interpretation Statement* concludes:

4.5.6 Accordingly, when considering whether s 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? It is considered that this is consistent with the tenor of the judicial approaches outlined above and encapsulates in a meaningful way the aim behind them.

Thus, while para 4.5.6 confirms the continuing relevance of scheme and purpose, para 4.1.1 implies that the approach is only relevant after it has been determined that an arrangement has a more than merely incidental purpose or effect of tax avoidance. In other words, it is first to be determined that s BG 1 prima facie applies, because the arrangement is literally a "tax avoidance arrangement", and then go on to determine whether it should apply in light of the scheme and purpose of the relevant specific provisions. The alternative approach is to read s BG 1 in light of the scheme and purpose of the relevant specific provisions, to determine whether the arrangement in question is a tax avoidance arrangement at all.

In many cases the same conclusion as to the application of s BG 1 would be reached whether the scheme and purpose of the specific provisions is analysed as the primary step, or only after it has been determined that s BG 1 literally applies. Nevertheless, this may not always be the case. Moreover, the logic of the approach in the *Interpretation Statement* is open to the criticism that it necessarily involves retracting (in appropriate cases) from the apparent finality of the conclusion that s BG 1 applies to an arrangement, whereas the alternative approach circumvents (in appropriate cases) the drawing of that uncomfortable conclusion altogether.

In an address to the annual conference of the Institute of Chartered Accountants of New Zealand on 16 October 2004, Sir Ivor clearly rearticulated his view that the scheme and purpose approach is the only proper basis for reconciling the specific regimes in the Act with s BG 1. Interestingly, when asked from the floor whether he considered that scheme and purpose was relevant to the primary question of whether an arrangement is a tax avoidance arrangement or, as the Commissioner suggests in the *Interpretation Statement*, relevant only after it has been concluded that, on a literal construction, s BG 1 does apply to an arrangement, he answered that his approach had always been to analyse the scheme and purpose of the specific provision at issue as the first and primary step. □