How to Clean Up the Mess:

A Critical Review of the Commissioner's Discretion to Reconstruct

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Introduction

In the last decade, the Commissioner of Inland Revenue ('the Commissioner') has clamped down on tax avoidance with great success. Jo Doolan, the tax director of Ernst & Young, described the situation as "duck shooting season" with the "anti-avoidance gun" shooting everywhere.[1] The landmark Supreme Court decisions of *Ben Nevis Forestry Ventures v Commissioner of Inland Revenue*[2] and *Penny & Hooper v Commissioner of Inland Revenue*[3], have recently led to numerous judicial, academic and professional discussion.[4] However, what has been neglected is discussion on the aftermath of finding an arrangement to be avoiding tax.

In brief, the 'tax avoidance process' can be summarised into three stages: determining whether there is tax avoidance arrangement,[5] reconstructing the arrangement to reassess the correct tax liability,[6] and imposing penalties and interests on the tax shortfall.[7] The primary focus of this dissertation will be on the second step, the Commissioner's power to reconstruct. However, in order to understand the significance of this power, we must first briefly introduce the law of avoidance, its process, and its complexity.

The Supreme Court in *Ben Nevis* established a three step process for finding tax avoidance. The first step is to determine whether there was an 'arrangement'.[8] Section YA 1 of the Income Tax Act 2007 ('ITA 2007') defines 'arrangement' as an agreement, contract, plan or understanding, whether enforceable or not, and includes all steps and transactions that form part of the plan.[9] The second step is to determine whether there is a 'tax avoidance arrangement'.[10] The definition of tax avoidance includes directly or indirectly altering the incidence of any income tax; relieving a person from liability to pay income tax; or avoiding, postponing, or reducing any liability to pay income tax.[11] The definition of tax avoidance arrangement is widely defined to include any

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1 Paul McBeth "Drink maker in tussle with IRD over $20m tax bill" (9 July 2010) stuff.co.nz <stuff.co.nz>.
2 *Ben Nevis Forestry Ventures Ltd and Ors v Commissioner of Inland Revenue* [2008] NZSC 115.
3 *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95
4 See for example Julie Cassidy "The Duke of Wester Minister should be 'very careful when he cross the road' in New Zealand: The Role of the New Zealand Anti-Avoidance Rule" (2012) 1 NZ L Rev 1; Mark Keating and Kirsty Keating "Tax Avoidance in New Zealand: The Camel's Back that Refuses to break" (2011) 17 NZJTLP 115; Michael Littlewood "Tax Avoidance, the Rule of Law and the New Zealand Supreme Court" (2011) 1 NZ L Rev 35.
5 Income Tax Act 2007, s BG 1.
6 Income Tax Act 2007, s GA 1.
7 Tax Administration Act 2004, pt 9.
8 *Ben Nevis Forestry Ventures Ltd and Ors v Commissioner of Inland Revenue*, n 2 above, at [160].
9 Income Tax Act 2007, s YA 1, definition of "arrangement".
10 Income Tax Act 2007, s YA 1, definition of "tax avoidance arrangement".
11 Income Tax Act 2007, s YA 1, definition of "tax avoidance".

arrangement that directly or indirectly has tax avoidance as its purpose or effect, or has tax avoidance as one of its purpose or effects, and that purpose or effect is not merely incidental.[12]

Interpreted literally, the definition of tax avoidance arrangement is capable of being applied to legitimate tax mitigation. Legitimate tax mitigation is where taxpayers take advantage of fiscally attractive opportunities and suffer the economic consequences intended by Parliament.[13] For example, it is a legitimate expense for a corporation to donate to charity. As long as the corporation donates the money, it can be deducted against the income before tax.

The difference between tax mitigation and tax avoidance has always been unclear. *Ben Nevis* distinguished the difference by elaborating on the relationship between the general anti-avoidance provision ('GAAR') and the 'specific provisions' that allow taxpayers to take advantage of various tax concessions. The Supreme Court held that GAAR should not be used to strike down every use of specific provisions, but only those arrangements that abuse the specific provisions in a way that is outside Parliament's contemplation. [14] The Supreme Court held:[15]

> Put at the highest level of generality, a specific provision is designed to give the taxpayer a tax advantage if its use falls within its ordinary meaning. That will be a permissible tax advantage. The general provision is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance. Its function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act.

In order to distinguish between legitimate tax mitigation and illegitimate tax avoidance, the Supreme Court laid down the "Parliamentary contemplation" test. If a taxpayer utilises a specific provision that altered the incidence of tax in a way that cannot have been within the contemplation of Parliament, the arrangement will be a tax avoidance arrangement.[16]

While this dissertation is primarily focused on the Commissioner's discretion to reconstruct, the intertwined relationship between tax avoidance and reconstruction inevitably means that tax avoidance will be discussed in-depth throughout the chapters.

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[12] Income Tax Act 2007, s YA1 definition of 'tax avoidance arrangement'.
[13] Keith Hooper "Tax avoidance" in Keith Hooper and others *Tax Policy & Principles: A New Zealand Perspective* (Brooker's, Wellington, 1998) at 162.
[14] *Ben Nevis Forestry Ventures Ltd and Ors v Commissioner of Inland Revenue*, n 2 above, at [103].
[15] At [106].
[16] At [107].

What is more important for the purpose of this dissertation is the third step of *Ben Nevis*.[17] Once the Commissioner finds that a particular arrangement falls foul of the GAAR, s BG 1(2) of the ITA 2007 states that the arrangement becomes void as against the Commissioner for income tax purposes.[18] This means that the tax consequences of the tax avoiding arrangement are annihilated. Any tax benefit obtained by the transaction or liability incurred no longer applies. However, the purpose of s BG 1(2) of ITA 2007 is to safeguard the operation of the Act and not to impose new liability.[19] Therefore, the power of reconstruction is required for the Commissioner to readjust the transaction in order to yield the correct tax liability. The voiding effect of the GAAR also annihilates any legitimate tax benefits obtained under the tax avoiding arrangement and these can only be reinstated by the Commissioner.

The Commissioner does not enjoy any power of reconstruction except by statute.[20] Section BG 1(2) creates the power and requires that it be exercised in accordance with s GB 1.[21] This general power conferred under s GA 1(2) states that "the Commissioner may adjust the taxable income in a way that the Commissioner thinks appropriate, in order to counteract a tax advantage obtained by the avoidance."[22]

However, due to the power being discretionary with the use of the statutory word 'may' and the lack of definition for 'tax advantage', issues of when and how the power should be exercised have created difficulties for the taxpayer.[23]

After reconstruction is complete, and the Commissioner reassess the correct tax liability, the taxpayer may be further penalised under part 9 of the Tax Administration Act.[24] Penalties range from 20% of the tax shortfall for 'not taking reasonable care'[25] to 100% penalty for taking an abusive position.[26] How the Commissioner exercises their power of reconstruction will also effect the amount of tax penalty. If reconstruction is exercised more favourable to the taxpayer,

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[17] *Ben Nevis Forestry Ventures Ltd and Ors v Commissioner of Inland Revenue*, n 2 above, at [163].
[18] Income Tax Act 2007, s BG 1(2).
[19] *Commission of Inland Revenue v Challenge Corporation Ltd* [1986] 2 NZLR 513 at 518; *Wisheart, Mcbab and Kidd v Commissioner of Inland Revenue* [1972] NZLR 319 (CA) at 337.
[20] *Vinelight Nominees Ltd v The Commissioner of Inland Revenue* [2013] NZCA 655 at [79].
[21] Income Tax Act 2007, s GB 1.
[22] Income Tax Act 2007, s GA 1(2).
[23] Mark Keating "Reconstruction of Tax Avoidance Arrangements: How Best to Rewrite History?" (2011) 17 NZJTLP 480 at 483; Timothy McLeod "'Reconstruction' or 'Destruction'?: The Approach of the Commissioner and the Court to Section GA 1" (2012) 18 NZJTLP 256 at 258; Thomas Faulls "The Commissioner's Power of Reconstruction under the General Anti-Avoidance Rule" (2013) 19 NZJTLP 27.
[24] Tax Administration Act 1994, pt 9.
[25] Tax Administration Act 1994, s 141A(2).
[26] Tax Administration Act 1994, s 141D(3).

the tax shortfall will be less and therefore lead to less penalty imposed, and vice versa. However, for the purpose of this dissertation, the penalties provision will not be examined.

Chapter one will give an in-depth historical account to the introduction and development of both legislative amendments and judicial interpretations of the reconstruction provision. The historical context will be split into two parts. The first part will discuss the origins and purposes of the reconstruction provision. The second will discuss the subsequent amendments of the reconstruction provision in the 1990s and how it affected the operation of the Commissioner's power to reconstruct.

Chapter two will review and analyse case law dealing with the Commissioner's discretion to reconstruct and reveal inconsistences in the law. It will evaluate the Interpretive Statement published by the Commissioner and determine whether it is consistent with the law; if so, whether the Commissioner has followed through in practice.

Chapter three will examine the relationship between the Commissioner's discretion and, the Rule of Law. The concern with the discretion to reconstruct is for the Commissioner to cross the line from the constitutionally permissible executive administration to the constitutionally impermissible executive taxation. However, at the same time, it is recognised that the discretion is required in order to allow an extent of flexibility for the Commissioner. In order to hold the Commissioner accountable and ensure the power is exercised within its statutory limits, this dissertation will recommend a principled approach in the application of reconstruction.

Chapter four will compare and contrast the New Zealand reconstruction provision with those of Australia and Canada. Specifically, this dissertation will discuss the GAAR advisory committee that Australia and Canada have established in reviewing the application of the GAAR.

Chapter One:

Historic Overview

1.1 The origins and purposes of the reconstruction provision

New Zealand did not have a reconstruction provision prior to 1976.[27] In the various forms of the land and income tax Acts, the GAAR provided that every scheme or arrangement which purports to alter the incidence of income tax is absolutely void.[28] The annihilating effect of the GAAR was sufficient to counteract all illegitimate tax advantages from deduction-based avoidance cases. For example, if a taxpayer claimed tax deduction for $1,000, and the deduction was later held to be tax avoidance, the annihilating effect voided all tax consequences. The Commissioner would therefore proceed to reassess the tax liability without requiring any adjustments to the transaction. However, where the arrangement involved income, the annihilating effect was insufficient to assess the correct tax liability. For example, if instead of the deduction, it was an income of $1,000 that was held to be tax avoidance. The annihilating effect would not automatically impose tax liability. The Commissioner therefore required a power conferred by statute to allow the income to be reconstructed in order to assess the tax liability.

The issue is further complicated by how the Commissioner goes about reconstructing the income. For example, a taxpayer sets up a company which employs himself. The company pays the taxpayer below market salary because the taxpayer's personal income tax rate was higher than the company income tax. If the Commissioner finds that the transaction is tax avoidance, it becomes difficult to reconstruct a sufficient salary for the taxpayer while allowing the company to retain reasonable profits. Chapter two will discuss the difficulties in reconstruction when there are legitimate economic substance in the arrangements.

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[27] See *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 (PC) for a comprehensive review on the history of New Zealand's GAAR provisions.
[28] Land and Income Tax Act 1954, s 108(1).

The Commissioner having no statutory power to reconstruct led to *Mangin v Commissioner of Inland Revenue.*[29] *Mangin* was a 'paddock trust' avoidance case where the taxpayer leased land to his family trust. The beneficiaries of the family trust were his wife and children. The taxpayer as trustee then employed himself to cultivate the land and advanced the profits from the trust to his wife and children.[30] This arrangement permitted the taxpayer to significantly reduce his tax liability by spreading the income among each individual family member. The Commissioner invoked the GAAR provision under the then s 108 of the Land and Income Tax Act 1954 ('LITA 1954') and proceeded to reassess the taxpayer's income to what would have been but for the existence of the paddock trust.[31]

The Privy Council was asked to decide on whether the Commissioner had the power to reassess the income tax liability after the arrangement was voided by the GAAR. The majority recognised significant flaws in the GAAR provision and held:[32]

> This contention throws into relief the difficulties caused by leaving a section such as section 108 completely silent as to what is to happen once the contract, agreement or arrangement has been declared absolutely void so far as its tax relieving purpose or effect is concerned. Is a vacuum left or is the taxpayer to be deemed to go on deriving the income? What is to happen if, simply in order to avoid tax, he has parted with the source of income? Or received money which is capital and not income? Section 108 gives no guidance at all on these points… What is needed is simply a provision to the effect that where section 108 applies the taxpayer shall be deemed to have derived the income which he would have derived but for the contract avoided by the section, and the Commissioner might make assessment upon him accordingly.

However, despite the statutory flaws, the majority reluctantly ruled in the Commissioner's favour. Through strenuous reasoning, their Lordships accepted that the appellant derived income from the sale of his crops.[33] By voiding the paddock trust under section 108, the appellant would be deemed to receive the income without any obligations to the beneficiaries.

A strong dissent delivered by Lord Wilberforce criticised the decision of the majority for crossing the limits of judicial interpretation.[34] His Lordship held that the GAAR provision was a "rusty instrument which breaks in our hands and is no longer capable of repair."[35] His Lordship argued that the taxpayer received the proceeds of the crops as an agent of the trust and not

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[29] *Mangin v Commissioner of Inland Revenue,* above n 27.
[30] At 593.
[31] At 593.
[32] At 597.
[33] At 601.
[34] At 605.
[35] At 605.

personally. Despite the disagreement in result, both the majority and minority in *Mangin* highlighted that the Commissioner needed a statutory power to adjust the tax avoiding arrangement.

Four years after *Mangin*, the New Zealand Court of Appeal decided *Gerard v Commissioner of Inland Revenue.*[36] The facts of the case were substantially similar to *Mangin*. The taxpayer agreed to lease portions of his farm to his family trust at full rental value. The trustee employed the taxpayer to cultivate the leased portion of the farm at the usual rate charged by agricultural contractors. The net income derived was distributed among the beneficiaries, the taxpayer's wife and his children.

Despite the factual similarity between *Mangin* and *Gerard,* the Court of Appeal ruled in favour of the taxpayer. Even though the taxpayer conceded that the arrangement avoided tax, the Court held that judges are not permitted to legislate in order to make the tax provisions work.[37] The Court of Appeal ended up adopting the reasoning of Lord Wilberforce in *Mangin* and held that the Commissioner failed to show the moneys have come into the taxpayer's hands.[38] Therefore, the Commissioner was not entitled to treat the income as derived by the taxpayer. It is sufficient to say that the win for the taxpayer in *Gerard* was the result of the Court's frustration towards the lack of legislative reform. In the opening judgment by McCarthy P, his Honour criticised the tax avoidance provision as "unworkable, forcing the Court to "tread its way through the uncertain swampland".[39]

The loss by the Commissioner prompted an amendment to s 108 of the LITA 1954. A comprehensive review chaired by prominent accountant, Mr LN Ross, was carried out in 1966.[40] The significant reforms that were recommended included discussions on the issues of tax avoidance and reconstruction. It is important to note how the Committee intended the reconstruction provisions to operate. The report stated:[41]

> A more equitable way of dealing with the situation would be to give the Commissioner a discretion to determine the liability for tax and the amount thereof as if the transaction had not been entered into or carried out, or in such other manner as in the circumstances of the case he deems appropriate for

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[36] *Commissioner of Inland Revenue v Gerard* [1974] 2 NZLR 279.
[37] At 286.
[38] At 284.
[39] At 280.
[40] LN Ross and others *Taxation in New Zealand: The Report of the Taxation Review Committee* (Government Printer, 1967).
[41] At [662].

> the prevention or diminution of tax avoidance. *This would enable him to assess tax as if the transaction had been a normal one between parties at arm's length and containing terms usual in such a transaction* (my emphasis).

This dissertation argues that the original intent in the operation of the reconstruction provision was to require the Commissioner to construct a hypothetical scenario when assessing the tax liability. In order for the Commissioner to "assess tax as if the transaction had been a normal one between parties at arm's length", the Commissioner will first need to consider what a normal arm's length transaction is before assessing the tax liability. The hypothetical scenario therefore would provide a benchmark to how the transaction is to be reconstructed.

As a result, s 108 of LITA 1954 was amended to state:[42]

> (2) Every arrangement made or entered into, whether before or after the commencement of this Act, shall be absolutely void as against the Commissioner for income tax purposes *if and to the extent that,* directly or indirectly,
>
> (a) its purpose or effect is tax avoidance.
>
> (3) where an arrangement is void… that arrangement *shall* be adjusted in such manner as the Commissioner considers appropriate so as to counteract any tax advantage obtained…

What is of interest to us later in this chapter is the use of 'to the extent' and 'shall'. These terms indicated that the Commissioner must reconstruct in finding that there was tax avoidance, and that reconstruction only applies "to the extent" to which the taxpayer gained an illegitimate tax advantage through reconstruction.

The interpretation of s 99 was discussed in the Court of Appeal[43] and Privy Council[44] decision of *Miller v Commissioner of Inland Revenue*. *Miller* involved the 'Russell template' where an accountant, Mr Russell, offered to take the entire net profit of the taxpayers every year in return for a tax-free capital. In the Court of Appeal, the taxpayer attempted to argue that had there not been the arrangement, most of the profit would have been retained by the taxpayer's company.[45] The Court firmly rejected this argument, stating that "the likelihood of receipt of moneys by the former shareholder must be judged by what they have actually done". Since the taxpayers removed all the profit from the company, it must therefore be assumed that they would not have left the money in the company.[46] This is an important principle that will be elaborated on

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[42] Income Tax 1976, s 99(2) (my emphasis).
[43] *Miller v Commissioner of Inland Revenue* [1999] 1 NZLR 275 (CA).
[44] *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 (PC).
[45] *Miller v Commissioner of Inland Revenue,* above n 43, at 301.
[46] *Miller v Commissioner of Inland Revenue,* above n 43, at 301.

throughout this dissertation. When reconstructing, the Commissioner should focus on the economic consequence of the taxpayer's activities and reconstruct the tax avoiding arrangement in light of actual events. It is not for the taxpayer to argue what they would have done had there not been a tax avoiding arrangement. Vice versa, it is not for the Commissioner to deny the economic consequences that the taxpayer has incurred when entering into the arrangement.

The Privy Council agreed with the Court of Appeal and held:[47]

> The Commissioner's duty is to make an assessment with regard to what in his opinion was likely to have happened if there had been no scheme. But that does not mean that he is actually rewriting history. The reconstruction is purely hypothetical and provides a yardstick for the assessment.

Their Lordships therefore contemplated the operation of the reconstruction provision to include a duty to consider a hypothetical scenario in order to provide a measure to assess the illegitimate tax advantage obtained by the taxpayer.

1.2 Unintended amendments during the rewrite project

In the late 1980s, the Valabh Committee undertook a comprehensive review of New Zealand's income tax system.[48] The *Final Report of the Consultative Committee on the Taxation of Income and Capital* recommended a rewrite in the scheme and drafting of the legislation. It recognised that it was difficult, if not impossible, to interpret much of the scheme and purpose of the Act.[49] Indeed, a study carried out in 1992 found that the average sentence in tax legislations consisted of 132 words.[50] The recommendation was followed by two further reviews, the Organisation Committee[51] and the recommendations by the Working Party.[52] What was emphasised by the subsequent reports and income tax Acts was the fact that the rewrite project was not intended to change the substance of the Act.

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[47] *Miller v Commissioner of Inland Revenue,* above n 44, at [22].
[48] Valabh Committee *Final Report of the Consultative Committee on the Taxation of Income from Capital: The Core Provisions of the Income Tax Act 1976, Key Reforms to the Scheme of Tax Legislation, Tax Accounting Issues, Operational Aspects of the Accruals Regime* (Valabh Committee, October 1992).
[49] At 36.
[50] Organisation Review Committee *Organisational Review of the Inland Revenue Department: report to the Minister of Revenue (and on tax policy, also to the Minister of Finance)*, Wellington, New Zealand (1994) at 81.
[51] Above n 50.
[52] *Working Party on the Re-organisation of the Income Tax Act 1976: second report of the Working Party* (Inland Revenue Dept., September 1993).

However, in 1996 Parliament enacted the Taxation (Core Provision) Act 1996 which stated:[53]

> **BG 1 Avoidance**
>
> *Arrangement void*
>
> (1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.
>
> *Enforcement*
>
> (2) The Commissioner, in accordance with Part G (Avoidance and Non-Market Transactions), *may* counteract a tax advantage avoidance by a person from or under a tax avoidance arrangement.
>
> **GB 1 Agreement purporting to alter incidence of tax to be void**
>
> (1) where an arrangement is void in accordance with section BG 1, the amount …*may* be adjusted by the Commissioner in the manner the Commissioner thinks appropriate, so as to counteract any tax advantage obtained by that person or under that arrangement.

There were two subtle but potentially significant amendments within the statute. The Commissioner's discretion was amended from a mandatory 'shall' to a discretionary 'may'. In a further effort to simplify the language, the words "to the extent' were removed.

It is unclear whether Parliament intended to amend s GA 1 in order to change the operation of the reconstruction provision. If the amendments were unintentional, the interpretation of the reconstruction provision should have remained the same as it was before the Tax (Provision) Act 1996. However, if the amendments were intentional, the change in the interpretation and operation of the reconstruction provision would have been justified.

Most commentators on New Zealand's reconstruction provision have thus far argued that the amendment was unintentional.[54] This is primarily due to the fact that the rewrite project was not intended to give any substantive change in the law.[55] As expressly stated in the commentary of the Taxation (Core Provisions) Bill 1995, considerable efforts were made to ensure that "the [B]ill does not contain any unanticipated or unintended changes".[56]

Nevertheless, there are two factors that potentially indicate that the amendment was intentional. When the Taxation (Core Provision) Bill 1995 was tabled for its first reading, s GB (1) was

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[53] Taxation (Core Provision) Act 1996, ss 6 and 240 (my emphasis).
[54] Keating, above n 23 at 483; McLeod, above n 23, at 258; Faulls, above n 23, at 32.
[55] Organisation Review Committee, above n 50 at 83.
[56] Taxation (Core Provision) Bill 1995 (136-2) at ii.

worded as "… … in calculating the taxable income of any person affected by that arrangement *will* be adjusted by the Commissioner in the manner the Commissioner thinks appropriate".[57] In the second and third readings, the "will" was crossed out and replaced with "may".[58] For this reason, Coleman concluded that the amendment was intentional and therefore justifies a new interpretation of the reconstruction provision.[59]

However, what Coleman did not notice was that the wording of s BG 1 never changed between the first reading and the second and third readings. From the first reading of the Taxation (Core Provision) Bill 1995, the wording of s BG 1 has always been "where an arrangement is void …the arrangement *may* be adjusted in such a manner that the Commissioner considers appropriate".[60] This remained consistent throughout the second and third readings.[61] It is therefore unclear whether the change between the first reading and the second and third readings of s GB 1 was intended to change the interpretation of the Act or merely to remain consistent with s BG 1.

The second factor that may have indicated that the change was intentional is the Valabh Committee report which was the catalyst of the entire rewrite project. Under the recommendation for reconstruction, the report stated:[62]

> We endorse our preliminary recommendation that:
>
> The Commissioner's power of reconstruction be discretionary.
>
> …

This could be read as a blatant endorsement by the Valabh Committee of amending the reconstruction provision. However, it is ambiguous whether the amendment was due to recommendations of the Valabh Committee. The recommendation of the Valabh Committee was not mentioned in any commentary on the passing of the Taxation (Core Provision) Bill 1995. It was also not mentioned in the subsequent report of the Organisation Committee or in the recommendations by the Working Party. In fact, in the first legislative rewrite of Income Tax

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[57] Taxation (Core Provision) Bill 1995 (136-1) at 187 (my emphasis).
[58] Taxation (Core Provision) Bill 1995 (136-2) at 211.
[59] James Coleman *Tax Avoidance Law in New Zealand* (CCH New Zealand Ltd, Auckland, 2013) at 154.
[60] Taxation (Core Provision) Bill 1995 (136-1) at 27.
[61] Taxation (Core Provision) Bill 1995 (136-2) at 29.
[62] Valabh Committee, above n 48, at 24.

Act 1994, the original statutory words were adopted.[63] There is therefore a confusion of whether the amendments are intentional or accidental.[64]

Consequently, the statutory wording of s GA 1 confers a wide discretion to the Commissioner. Chapter two will discuss how this wide discretion has led to uncertainty and inconsistency in the application of the discretion.

[63] Income Tax Act 1994, s GB 1.
[64] A Rewrite Advisory Panel was established in 1995 to consider and advise on issues arising during the rewriting of the Income Tax Act 1994. As noted by Faulls, above n 23, the issue of unintended amendments to the reconstruction provision has been raised with the Rewrite Advisory Panel by Russell McVeagh. However, no action has yet been indicated.

Chapter Two:

Problems with the Status Quo

In 2013, the Commissioner issued the *Interpretive Statement: Tax Avoidance and the Interpretation of Section BG 1 and GA 1 of the Income Tax Act 2007* ('the Interpretive Statement').[65] The Commissioner separated the discussion of the reconstruction provision into two categories. First, when the discretion will be exercised. Second, how the discretion of reconstruction will be exercised. This dissertation will therefore follow the structure of the Interpretive Statement[66] and discuss whether the approach taken by the Commissioner was appropriate, and if so, whether the case law on the reconstruction provision reflects the Commissioner's approach.

2.1 Commissioner's discretion as to <u>when</u> to reconstruct

The current reconstruction provision lies in s GA 1, with statutory wording very similar to the Taxation (Core Provision) Act 1996. It confers a discretion to adjust taxable income in a way the Commissioner thinks appropriate in order to counteract a tax advantage obtained by the person.[67] The Interpretive Statement has held that the discretion will be exercised by asking the following three questions:[68]

1. Has the voiding effect of s BG 1 completely counteracted the tax advantage from the tax avoidance?
2. Has the voiding effect of s BG 1 removed any tax outcomes?
3. Are any consequential adjustments required to ensure appropriate outcomes?

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[65] Inland Revenue *Interpretive Statement: tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (Public Rulings Unit, Office of the Chief Tax Counsel, IS 13/01, June 2013).
[66] However, it is also recognised that the issue of *when* to reconstruct is interlinked with the issue of *how* to reconstruct. Due to the interdependent nature, some discussions will inevitably cross over.
[67] Income Tax Act, 2007, s GA 1(2).
[68] Inland Revenue, above n 65, at 115.

If question one is answered in the negative, or if question two or three are answered in the positive, the Commissioner will exercise the discretion to reconstruct. It is sometimes misconceived that the power of reconstruction only applies to income cases and not deductions.[69] While it is true that the voiding effect will often be sufficient to counteract tax advantages involving deductions, this dissertation argues that there are circumstances in which reconstruction is also required in deduction cases in order to reinstate legitimate tax deductions.

In terms of interpreting s GA 1, the Commissioner has stated that the word 'may' does not confer the Commissioner a complete discretion.[70] The Commissioner has recognised that reconstruction is required in circumstances where the voiding effect has removed a 'legitimate tax outcome' or where consequential adjustments are needed. However, a legitimate tax outcome is distinguished on the basis of its relationship with the tax avoidance arrangement as opposed to a reflection of the economic consequences. The Statement states:[71]

> … [A]djustment to reinstate legitimate tax effects are ones the Commissioner thinks are appropriate. When considering whether a tax effect is legitimate, the Commissioner considers that parts of the arrangement that are so interdependent and interconnected with the tax avoidance parts as to be integral to them would not be reinstated by the operation of s GA 1. This will be the case even if the part of the arrangement, when viewed in isolation, or in the context of a different arrangement, would be argued to be legitimate

The term 'legitimate tax outcome' is not referred to or defined under the Income Tax Act 2007 ('ITA 2007'). Put simply, any tax advantage is voided as long as it is integral to the tax avoidance arrangement. The Commissioner cited *Ben Nevis*[72] as examples where legitimate tax outcomes were reinstated. However, this dissertation argues that *Ben Nevis* reinstated tax deductions not because they were independent of the tax avoidance arrangement but rather in recognition of the economic consequence suffered by the taxpayer.

The difference between legal and economic consequence was explained by Susan Glazebrook in *New Zealand Accrual Regime - A practical Guide* being:[73]

> [The traditional] legal/ accounting approach to defining what constitutes income can be compared with an economic approach. Under economic principles, all gains in wealth are generally considered to be "income" and all reductions in wealth are subtracted from income. Whether any "gain" or

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[69] James Coleman, above n 59, at 153.
[70] Inland Revenue, above n 65, at 106.
[71] At [454].
[72] *Ben Nevis v Commissioner of Inland Revenue*, above n 2.
[73] Susan Glazebrook and Robin Oliver *The New Zealand accrual regime - a practical guide* (Tax Education Office, New Zealand Commerce Clearing House New Zealand 1989) at 50.

> "loss" can be categorised as capital or revenue assumes no relevance, the only issue is whether there is an overall gain or loss of wealth over the period of which the income is being measured.

The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such a reduction in his liability.[74] When considering whether there was a tax avoiding arrangement, the courts are not limited to purely legal considerations. They also consider commercial reality and economic effect of the impugned arrangement.[75] This dissertation argues that the reconstruction provision should be consistent with the approach taken in finding tax avoidance. When reconstructing, the Commissioner should examine whether there were any deductions of real economic wealth by the taxpayer that was within Parliament's contemplation.

Ben Nevis was concerned with 'loss attributing qualifying companies' which participated in the development of a forest project that was due to be harvested in 2048. The taxpayers claimed deductions for insurance premiums of $34,098 and a depreciation allowance of around $2 million to be spread over the next fifty years. The Commissioner held this to be tax avoidance and disallowed these deductions, but reinstated the actual cost of planting and tending to the trees.[76] While the Supreme Court held that this reinstatement was appropriate because planting and tending to the trees were not part of the tax avoidance arrangement, it is argued that the entire arrangement was based on taking advantage of specific tax concessions derived through industrial tree planting. It does not make sense to reinstate the deduction based on whether it was an integral part of the arrangement. Instead, reinstatement should be based on whether there were actual economic consequences suffered by the taxpayer. By planting and tending to the trees, the taxpayer engaged in fiscal activities intended by Parliament and suffered economic consequences allowed by the ITA 2007.

Therefore, the Interpretive Statement was arguably incorrect to state that whether a legitimate tax outcome is determined based on whether it is integral to the arrangement. The best way to reconstruct an arrangement that has avoided tax is to consider the actual economic consequence suffered by the taxpayer.

However, this was not the approach taken in *Alesco New Zealand Ltd v Commissioner of Inland Revenue* ('*Alesco*').[77] Alesco Corporation ('Alesco Australia'), a West Australian-based company,

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[74] *Inland Revenue Commissioners v Willoughby* [1997] 1 WLR 1071.
[75] *Ben Nevis v Commissioner of Inland Revenue*, above n 2, at [109].
[76] *Ben Nevis v Commissioner of Inland Revenue*, above n 2, at [31].
[77] *Alesco New Zealand Ltd vs Commissioner of Inland Revenue* [2013] NZCA 40.

advanced $78 million to fund their New Zealand subsidiary ('Alesco NZ') for the purchase of shares in Biolab Limited and assets of Robin Industries Ltd. In return, Alesco NZ issued optional convertible notes ('OCN'), which did not bear any interest and were for a fixed term of 10 years. On maturity Alesco Australia was entitled to exercise an option to either convert the OCN into shares or cash.

Alescso Australia chose this funding instrument because Australian and New Zealand tax authorities treat OCN differently. In Australia, OCNs are treated as 100% equity and therefore the interest received from would not be assessable for Alesco Australia. However, in New Zealand OCN are a hybrid instrument, which would mean that interest paid by Alesco NZ would be tax deductible.[78] Due to the asymmetrical manner in which the OCN were treated, the Commissioner embarked on a nation-wide crackdown. Indeed, Alesco was not the only company pursued. Telstra, Tall Holdings, Media Works, and Frucor were all caught by the anti-avoidance provision and settled with the IRD.[79]

The Court found that the arrangement undertaken by Alesco NZ constituted tax avoidance because the optional convertible had no practical value.[80] Alesco NZ was already fully owned by its parent company and therefore the option to convert the OCN to shares was artificial and contrived.[81] The taxpayer argued that there was no tax avoidance because the hypothetical scenario using the market rate interest would allow Alesco NZ greater deduction.[82] However, the Court strongly rejected the submission that taxpayers can benefit from their own wrong doing. It held that the application of GAAR taken by *Ben Nevis* does not require the Commissioner to identify the tax advantage in finding that there was tax avoidance.[83] However, chapter four will discuss how identification of tax advantage in Canada and Australia is required for applying the GAAR.

In terms of reconstruction, the taxpayer argued that the Commissioner is under a positive duty to consider the next most likely alternative.[84] Even though the use of OCN was held to be tax avoidance, there was no doubt that the acquisition of Biolab Ltd and Robinson Ltd is completely genuine. Evidence was submitted by an expert accountant, Mr Fonseca, on how the arrangement

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[78] At [13].
[79] Rob Hosking "Court of Appeal gives IRD another big tax win" *National Business Review* (New Zealand, March 5 2013).
[80] *Alesco New Zealand Ltd v Commissioner of Inland Revenue*, above n 77, at [11].
[81] At [11].
[82] At [33].
[83] At [39].
[84] At [121].

would have been carried out if the OCN was not adopted. In Mr Fonesca's expert opinion, the transaction would have been carried out through a normal loan at market rate interest.

However, the Commissioner submitted that the voiding effect cured the impermissible tax advantage and reversed any tax deductions by Alesco NZ.[85] The Court upheld the Commissioner's decision not to positively exercise her discretion to reinstate any interest deductions from the void arrangement. However, the voiding effect of s BG 1, without reconstruction, means that the arrangement amounted to an interest free loan. Ironically, as Keating notes, this position would have never been taken by the taxpayer because it is likely to be in breach of the transfer pricing rules under ss GC 6 to GC 14.[86]

This dissertation argues that recognising legitimate tax outcomes in deduction cases such as *Alesco* should be consistent with recognising legitimate tax outcomes in income cases. *Alesco* is arguably analogous to *Penny & Hooper* to the extent that both tax avoidance arrangements had a legitimate business purposes with genuine transfer of economic wealth. *Penny & Hooper* concerned two orthopaedic surgeons who established a company for which the individual taxpayer was the sole director and the shares were held in their family trust. The surgeons sold their profitable practices to the company and employed themselves under their newly established company. At the time, the maximum personal income tax rate was 39% while the distribution of dividends through the family trust was only 33%. The company therefore paid the surgeons below market rate salary and avoided paying up to $20,000- $30,000 per annum in income tax.[87] The Court agreed with the Commissioner that the below market value constituted tax avoidance.

From the outset, the Commissioner was willing to recognise that there was genuine economic substance in the arrangement. Rather than taxing the entire company's profit as personal income tax, the Commissioner reassessed the taxpayer's income at a commercially realistic salary. This approach should have been taken in *Alesco.* Like *Penny & Hooper,* Alesco Australia also had a genuine business purpose in funding the New Zealand subsidiary. Like *Penny and Hooper,* there was also a transfer of economic wealth. The only difference is that *Penny & Hooper* is an income case whereas *Alesco* is a deduction case. The Commissioner's approach in *Alesco* should have given recognition to the economic substance of the transaction and not focused on whether the legitimate tax outcome was integral to the tax avoidance arrangement.

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[85] At [120].
[86] Keating, above n 23, at 502.
[87] *Penny & Hooper v Commissioner of Inland Revenue*, above n 3, at [2].

Alesco also illustrated the consequences of the modern judicial approach for tax avoidance. In cases like *Miller* and *Ben Nevis,* the arrangements were egregiously artificial in that the taxpayer did not suffer any economic consequences at all. Therefore, the reconstructions were straightforward and the Commissioner denied all income and expenses that arose out of the tax avoiding arrangement. In contrast, there was legitimate economic substance when the parent company in Australia funded the subsidiaries in New Zealand. Under these circumstances, it seems inappropriate and unfair to completely void all components of the transaction.

2.2 Commissioner's discretion as to <u>how</u> to reconstruct

Once the Commissioner decides to invoke their discretion to reconstruct, the next question is how the discretion will be exercised. The ITA 2007 confers the Commissioner a wide discretion with limited guidance as to how the power is to be carried out. The relevant statutory guidance is as follows:[88]

> *Commissioner's general power*
>
> (2) The Commissioner may adjust the taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate, in order to counteract a tax advantage obtained by the person from or under the arrangement.
>
> *Commissioner's specific power over tax credits*
>
> (3) The Commissioner may-
>
> (a) Disallow some or all of a tax credit of a person affected by the arrangement; or
>
> (b) Allow another person to benefit from some or all of the tax credit.
>
> *Commissioner's identification of hypothetical situation*
>
> (4) When applying subsection (2) and (3), the Commissioner may have regard to 1 or more of the amounts listed in subsection (5), which, in the Commissioner's opinion, had the arrangement no occurred, the person-
>
> (a) Would have had; or
>
> (b) Would in all likelihood have had; or

[88] Income Tax Act 2007, s GA 1.

(c) Might be expected to have had

Reconstructed amounts

(5) The amount referred to in subsection (4) are-

(a) an amount of income of the person;

(b) an amount of deduction of the person;

(c) an amount of tax loss of the person;

(d) an amount of tax credit of the person.

No double counting

(6) when applying subsection (2), if the Commissioner includes an amount of income or deduction in calculating the taxable income of the person, it must not be included in calculating the taxable income of another person.

The only mandatory provision in s GA 1 is subsection (6), where the Commissioner *must* not double count when calculating taxable income. All other subsections in GA 1 are discretionary, using the word 'may'.

2.2.1 Unconstrained discretion?

The Interpretive Statement has emphasised the wide discretionary nature of how the Commissioner carries out the power of reconstruction.[89] It held that the discretion is used to in order to counteract any illegitimate tax advantage; reinstate legitimate tax outcomes; and/or adjust any appropriate tax consequences.[90]

The position taken in the Interpretive Statement came after *Westpac Banking Corp v Commissioner of Inland Revenue*[91] and *Alesco* where the Courts gave an expansive interpretation to the Commissioner's discretion. Both cases, from the High Court and the Court of Appeal respectively (although both decided by Harrison J), gave an almost unconstrained discretion to

[89] Inland Revenue, above n 65, at 108.
[90] At 115.
[91] *Westpac Banking Corp v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834.

the Commissioner. *Westpac* was part of an IRD crackdown by major banks in New Zealand taking part in 'repo deals'.[92] The facts can be briefly summarised as follows:[93]

> Westpac, acting through subsidiaries, purchased preference shares issued by a specifically formed subsidiary within a counterparty group of companies in the United States and United Kingdom. Another subsidiary within the group assumed an obligation to repurchase the shares in five years or less. Westpac paid that subsidiary a fee, known as the guarantee procurement fee or GPF, to procure the parent company's guarantee of the subsidiary's obligations.
>
> The Counterparty jurisdiction treated the transaction for taxation purposes according to their economic substance as loans. Dividend payable on the shares were thus deductible interest for the issuer. By contrast, New Zealand revenue law treated the dividend according to their legal form as income returned to Westpac on equity investments which was exempt from taxation liability.

Additional to the cross-border asymmetry, Westpac was claiming deductions for the expenses incurred from third parties; including the borrowing cost, GPF, and the net interest rate cost of borrowing.[94] The Courts held that the 'repo deals' lacked economic substance and therefore constituted tax avoidance. The Commissioner refused to allow any expenses incurred in the transaction.

This dissertation is concerned with the approach the Court took in giving the Commissioner an almost unconstrained discretion. His Honour held that the Commissioner is not required to precisely determine what constituted tax avoidance or identify particular aspects that gave rise to a 'tax advantage'.[95] His Honour further held that the Commissioner is not required to isolate out and counteract particular elements giving rise to a tax advantage.[96]

This approach is inconsistent with the Interpretive Statement. On the one hand, the Interpretive Statement states that the Commissioner will reinstate any legitimate tax outcomes that are not integral to the tax avoiding arrangement. On the other hand, the Commissioner is not required to identify precisely what constitutes a tax advantage or identify particular aspects that gave rise to a 'tax advantage'. This interpretation also seems contradictory to the statutory wording of s GA 1, where the duty of the Commissioner is to make adjustments to counteract tax advantages obtained in or under the arrangement.

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[92] Lucy Craymer "First barb in $2b battle between banks and IRD" *National Business Review* (New Zealand, May 20 2009).
[93] *Westpac Banking Corp v Commissioner of Inland Revenue,* above n 91, at [3]-[4].
[94] At [6].
[95] At [639].
[96] At [641].

The approach taken in *Westpac* demonstrated the unconstrained discretion the Court has been willing to give the Commissioner. This has sometimes led to absurd results to the detriment of the taxpayer. The best illustration is *Kruizner v Commissioner of Inland Revenue.*[97] Mr Kruziner was a property investor and developer who operated through a group of companies and trading trusts. He received a nominal salary from the group. However, he borrowed $5 million from the current accounts of the trusts and companies. The Commissioner held that the arrangement constituted tax avoidance and treated the loan as the personal income of the taxpayer.

Keating argues that treating the loan as personal income tax was incorrect because the tax advantage obtained under the arrangement was "not the enjoyment of the loan but their interest-free nature".[98] Interest free loans are already adequately catered for under the fringe benefit regime in the ITA 2007. Under s CX 10, any loan provided at a favourable interest rate or no interest rate at all gives rise to fringe benefit tax.[99] The tax is calculated by comparing the interest on the loan with interest using the 'prescribed' rate.[100] According to the IRD website, the prescribed interest rate in the 1990s, ranged between 9-11%.[101] With fringe benefits taxed at 49.5%, the tax avoided under the arrangement would at most be around $272,000. However, if we treat the loan as personal income, tax would be calculated at 33% on the entire $5 million. This equates to an avoidance of around $1.65 million dollars.[102]

It was also concerning that the Court accepted the Commissioner's reconstruction without examining the 'tax advantage' obtained, or appreciating the alternative (and more appropriate) hypothetical scenario.[103] Pagone argued that one reason why tax avoidance is often inconsistent is due to lawyers and judges not understanding financial and economic concepts.[104] Therefore, when coming to reconstruct an arrangement, they are unable to appreciate the alternative ways to reconstruct the arrangement. This problem could be resolved by setting up a GAAR panel which will be discussed in chapter four.

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[97] *Krukziener v Commissioner of Inland Revenue* (2011) 24 NZTC 24,563 (HC).
[98] Keating, above n 23, at 501.
[99] Income Tax Act 2007, s CX 10.
[100] *New Zealand Master Tax Guide for Students* (CCH New Zealand, Auckland, 2001) at 945.
[101] "Fringe Benefit Tax on specific categories of benefit: Low-interest loans" (27 August 2015) Inland Revenue <www.ird.govt.nz>.
[102] *New Zealand Master Tax Guide for Students,* above n 100, at 946.
[103] Keating, above n 23, at 501.
[104] Tony Pagone "Some Problems in Legislating for Economic Concepts - a Judicial Perspective" (2011) 1 *Economic Round-up* (2011) 39 at 43.

2.2.2 Applicability of hypothetical scenarios

A further issue is the use of hypothetical counterfactuals when the Commissioner exercises the discretion to reconstruct. Even though s GA 1(4) is discretionary, it demonstrates that Parliament contemplated the Commissioner constructing hypothetical scenarios contemplating what the taxpayer would have received had the tax avoidance arrangement not occurred. As established in chapter one, the purpose of the reconstruction provision is to allow the Commissioner to adjust the tax avoidance arrangement so that it is "a normal one between parties at arm's length and containing terms usual in such a transaction".[105] In order to achieve this, the Commissioner is required to consider hypothetical arrangements as a benchmark of how the reconstruction should been carried out.

However, the Interpretive Statement of s GA 1(4) emphasises the discretionary nature of the requirement of setting a hypothetical benchmark to assess illegitimate tax advantages obtained. This interpretation was published after *Alesco,* where the Court of Appeal held that:[106]

> The terms of s GB 1 are plain. In exercising her discretion the Commissioner 'may have regard to' an alternative funding arrangement. But she is not bound to take that step, and nor should she be where the tax advantage can be counteracted simply by disallowing the impermissible deductions. It is immaterial that Alesco NZ required the funding for a new acquisition.

The Court has given a broad interpretation, placing emphasis on "in the Commissioner's opinion" and "may have regard to" under s GA 1. However, in *Alesco,* the Court misunderstood the rationale behind why the taxpayer submitted an alternative hypothetical counterfactual. Alesco NZ was not arguing what would have happened if the taxpayers did not enter this arrangement. What the taxpayer was arguing was how to recognise the economic substance of the loan between the parent company and its subsidiary if the OCN were not adopted. It is non-contentious that there was a transfer in economic value between the parenting company and its subsidiary. The issue is how we should reconstruct the legal form in a way that does not fall foul of the GAAR.

The Court's disregard of any genuine commercial purpose existing in the tax avoiding arrangement is unfairly punitive on the taxpayer. The Commissioner now seems to be able to have her cake and eat it too. While looking for tax avoidance, we examine the economic

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[105] LN Ross and others, above n 40, at 266.
[106] *Alesco New Zealand ltd v Commissioner of Inland Revenue*, above n 77, at [123].

substance over the legal form of the transaction. However, when carrying out the reconstruction, the Commissioner is not required to consider the economic consequences incurred in the transaction.

The decision in *Alesco* was heavily influenced by the Court's discontent with the taxpayer trying to profit out of their own wrongdoing. The alternative hypothesis of a market rate interest, proposed by the taxpayer, would have allowed greater tax deduction for the taxpayer than under the OCN. This would have clearly defeated the purpose of holding the transaction to be tax avoidance in the first place if the taxpayer was allowed to benefit from the alternative.

2.3 Recommendation: the use of commercial counterfactuals

This dissertation argues in order to determine when and how the Commissioner is to exercise the power of reconstruction, she should not be focusing on identifying features that are integral to the transaction. Under s GA 1(2), the statutory language expressly requires the 'tax advantage' to be counteracted.[107] In circumstances such as *Alesco* where there are legitimate economic purposes in the arrangement, the Commissioner has a duty to recognise the legitimate tax base and only counteract the illegitimate tax advantage. This approach was taken by McGechan J in *BNZ Investment Ltd v Commissioner of Inland Revenue* where his Honour held:[108]

> Where tax advantages are increased through avoidance over a base level which would have existed in any event, *it is that increment above base level which is to be counteracted, not the legitimate base level itself.* That is all preservation of the tax base, the purpose of the section, requires.

Coleman labelled this approach as the 'commercial counterfactual', the idea being:[109]

> The identification of an acceptable method, in tax law terms, of achieving the same commercial outcome. The rationale is that it is the difference between the taxpayer under that alternative compared to the taxable under the impugned arrangement that constitutes a tax advantage, which the Commissioner may counteract.

The commercial counterfactual approach reflects how the GAAR was intended to work prior to the rewrite. The tax avoidance arrangement would be voided *so far as* it constituted avoidance.

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[107] Income Tax Act 2007, s GA 1(2).
[108] *BNZ Investment Ltd v Commissioner of Inland Revenue* (2009) NZTC 15,732 (HC) at [200].
[109] James Coleman, above n 59, at 160.

Only the illegitimate tax advantage would be counteracted; any legitimate tax advantage should be left alone.

However, there should be limits in inquiring into commercial counterfactual scenarios. As the Court of Appeal in *Miller* held, when reconstruction is carried out the Commissioner is to look for what the taxpayer has actually done and not what the taxpayer would have done. This allows greater certainty of how reconstruction is to be carried out. The Commissioner would not be required to venture into the infinite possibilities of what would have happened if the taxpayer had not entered into the tax avoiding transaction.

2.3.1 Limitations to the commercial counterfactual approach

It is recognised that the commercial counterfactual approach is not the be all and end all solution to the reconstruction provision. Even where the Commissioner only looks at what the taxpayer has done in the tax avoiding arrangement, it is still possible to construct more than one commercial counterfactual scenario. This can be demonstrated by *Case W 33*,[110] where the facts were similar to *Penny & Hooper*. A dental surgeon restructured his partnership by selling his practice to a trading trust, in which his wife and children were the beneficiaries. The dentist then became an employee of the trading trust and was paid a below market salary, with the remaining income distributed among the beneficiaries, which resulted in tax savings over the income years under investigation. The issue of whether it constituted tax avoidance was controversial,[111] but this dissertation is concerned with how the reconstruction was carried out and not whether it was avoidance. Evidence by the taxpayer argued that the market salary in the locality was around $80,000, while the Commissioner argued that the salary should be based on a commission rate which amounted to $159,000 in the relevant year. Judge Barber, reaching a compromise without a principled basis, set the salary at $120,000.[112]

The various options proposed by the taxpayer, the Commissioner and the Court demonstrates the complexity of recognising the correct commercial counterfactual scenario. The problem with the Commissioner's proposal is that in arm's length dealings, employers pay their employees on predetermined salaries rather than calculating their salaries by subtracting a fixed return on their

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[110] *Case W33* (2004) 21 NZTC 11,321.
[111] Stephen Tomlinson "Trading Trusts, Tax Avoidance and Personal Service Income" (paper presented to New Zealand Law Society Conference, September 2006) 89 at 90.
[112] *Case W33*, above n 110, at [40].

investment.[113] Employees would not be prepared to work on a commission either, as it shifts the business risk from the employer to the employee irrespective of how the business performs. The Commissioner was in fact disrespecting the corporate veil. It was the trading trust that provides the professional service, not the dentist himself.

However, even the taxpayer's submission on reconstructing upon market rate salaries has its conceptual difficulties. Under s GB 1(4), the Commissioner may have regard to what the taxpayer would have had, would in all likelihood have had, or might be expected to have had. There is no statutory requirement that arrangement must be reconstructed in accordance with the market rate. This is analogous to *Commissioner of Inland Revenue v Auckland Harbour Board,* where the Privy Council held that "it is impossible to find a general legislative intention that all transfers for no consideration should be treated as having been at market value."[114] The Court's approach of reaching a compromise without an evidentiary basis demonstrates the ad hoc attitude the courts are taking in reconstructing tax avoidance cases.

The Commissioner has published a statement which holds that single shareholding companies such as those in *Case W33* and *Penny and Hooper* will not be caught by the anti-avoidance arrangement if 80% of their income is taxed at the personal rate.[115] This statement is problematic due to principle and pragmatic considerations. Under the Companies Act, a director who pays too much salary can be in breach of reckless trading.[116] By paying 80% of the company's income to an employee, creditors who brings a claim in the event that the company goes under will be able to claim that the director breached his statutory duty to not trade recklessly. On a more principled level, the dissertation is uncomfortable with the 80% rate set by the Commissioner and not by Parliament. While the Interpretive Statement gives increased clarity as to how single shareholder companies can arrange their affairs without being caught by s BG 1, the fact that it is the executive branch ordering the affairs of taxpayers, and not the legislature, rings alarming constitutional concerns.

In order to choose the best commercial counterfactual scenario as benchmark for assessing tax liability, the Commissioner should consider the Australian approach. As will be discussed in chapter four, Australia requires the Tax Office to consider certain factors; including the most straightforward method of reconstruction, commercial and social norms, family and relationship

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[113] Stephen Tomlinson, above n 111, at 90.
[114] *Commissioner of Inland Revenue v Auckland Harbour Board* (2001) 20 NZTC 17,008 (PC) at 17,012.
[115] "Technical tax area: Revenue Alerts 11/02" (31 August 2011) Inland Revenue <www.ird.govt.nz>.
[116] Companies Act 1993, s 135.

obligations, and cash flow in the arrangement. This dissertation does not advocate for a 'one size fits all' solution to how reconstruction should be carried out. As chapter three will discuss, flexibility in the Commissioner's discretion is required in reconstruction. This dissertation is more concerned with the unconstrained nature of the discretion that has led to an unprincipled and inconsistent application of the law.

What is urgently required in the ITA 2007 is a definition of 'tax advantage' for s GA 1 and clarification on the reconstruction provision. As not all tax advantages are necessary illegitimate, the legislation should provide a definition of what the Commissioner is required to counteract. Furthermore, the legislation also fails to successfully link the illegitimate tax advantage obtained and the tax avoidance arrangement carried out. Under s GA 1(5), legislative language of 'the reconstructed amount' gives no reference to the illegitimate tax advantage obtained in the tax avoidance arrangement. All it states is an amount of income, deduction, tax loss, or tax credit of the person.[117] The poor legislative drafting does not therefore focus on the 'amount to be reconstructed' to the tax advantage obtained under the tax avoidance arrangement. If the definition of 'tax advantage' set out in s BG 1 is limited to illegitimate tax advantage derived by the tax avoidance, the Commissioner will be compelled to exercise the discretion within the scope of counteracting the illegitimate element of the arrangement. Identifying the tax avoiding elements of the arrangement will often also require the Commissioner to construct a hypothetical scenario.

2.4 Burden of proof

A brief comment should be made on the burden of proof for the taxpayer in submitting an alternative reconstruction scenario. Section 18 of the Tax Administration Act 1994 ('TAA') states that:[118]

> On the hearing and determination of any objections… the burden of proof shall be on the objector.

In *Ben Nevis,* the Supreme Court held that the taxpayer had the onus of proving "not only that the reconstruction was wrong, but also by how much it was wrong."[119] The taxpayer has the onus of establishing with reasonable clarity how the Commissioner's reconstruction was not within the statutory scope. In order to avoid this issue, counsel for *Alesco* submitted evidence to

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[117] Income Tax Act 2007, s GA 1(5).
[118] Tax Administration Act 1994, s 18.
[119] *Ben Nevis v Commissioner of Inland Revenue,* above n 2, at [171].

demonstrate how the transaction would have been structured if OCN was not chosen. The expert evidence, not challenged by the Commissioner or Heath J in the High Court, affirmatively proved that in all likelihood they would have had a loan with market interest. This evidence was submitted to satisfy the taxpayer's burden under s 18 of TAA. However, when considering the evidence, the Court of Appeal held:[120]

> Mr Fonseca's evidence was not relevant because it had no probative value. His reconstruction was not based on facts but was a detailed rationalisation of events which never occurred. It was a speculative exercise conducted in an evidential vacuum and reads like a lawyer's argument on the relative merits of the possible alternatives. There would be no purpose in allowing Mr Fonesca an opportunity to answer these criticisms because the Court would have been unable to give any weight to his answers.

The taxpayer is now in a serious dilemma. On the one hand, they have the onus of proving how the transaction would have been reconstructed if not for the tax avoiding arrangement. On the other hand, any evidence produced by counsel would be inadmissible because it is a 'speculative exercise conducted in an evidential vacuum.'

The Court seemed to suggest that the burden of proof could only be satisfied if there were minutes kept at the time of structuring the transaction that would show what the taxpayer would have done if the OCN transaction were not entered into. There are two problems with this suggestion. First, taxpayers who do not originally intend on avoiding tax, or genuinely believe that their transaction were legitimate tax mitigation, will often not be in the habit of recording an alternative approach. Second, if there were evidence of two alternative approaches, and the taxpayer chose the alternative that paid less tax, this conscious choice may amount to an abusive tax position where the penalty is 100 per cent if the Commissioner later found the transaction to be tax avoidance.[121] Whether the Commissioner is required to consider a hypothetical scenario is beside the point. The statutory language in s GA 1(4) is mostly speculative. Parliament therefore must have contemplated that hypothetical reconstruction would have been admissible.

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[120] *Alesco New Zealand Ltd v Commissioner of Inland Revenue*, above n 77, at [45].

[121] However, this might not matter with the current interpretation of 'purpose' by the Supreme Court in *Ben Nevis*. If what we are looking at is not the purpose of the taxpayer but the purpose of the transaction, almost all tax avoidance cases would be taking an abusive tax position. For more commentary see: Shelley Griffiths "An abusive tax position" [2013] NZLR 392.

Chapter Three:

The Reconstruction Provision and the Rule of Law

In *Tax, Discretion and the Rule of Law,* Dominic de Cogan starts off by stating that "few aspects of revenue law generate stronger feelings than the exercise of discretionary power by tax authorities".[122] Indeed, the concern is that the Commissioner will cross the constitutionally permissible line of executive tax administration to the constitutionally impermissible line of executive tax legislation. In *Auckland Harbour Board,* the Privy Council reinforced the principle that the GAAR cannot be invoked to rewrite tax law. Hoffman LJ held that such interpretation "would amount to the imposition of tax by administration discretion instead of the law." [123] The public law principles of the Rule of Law and Separation of Powers ensure that the Commissioner exercises the power of reconstruction within its constitutional limits. This chapter will examine the concept of the Rule of Law and its relationship with the exercise of administrative discretions. While this dissertation concedes that a discretion is required in the operation of the GAAR provision, this discretion must be constrained in order to ensure certainty, transparency, consistency and accountability.

3.1 The concept of the Rule of Law and its relationship with the discretion to reconstruct

The Rule of Law is inherent to New Zealand's constitutional framework. However, there are various interpretations for what is meant by the Rule of Law. For simplicity, this dissertation will

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[122] Dominic de Cogan "Tax, Discretion and the Rule of Law" in Chris Evans and Judith Freeman and Richard Krever *The Delicate Balance: Tax, Discretion and the Rule of Law* (IBFD, the Netherlands, 2011) at 1.
[123] *Commissioner of Inland Revenue v Auckland Harbour Board*, above n 114, at 17,012.

adopt the interpretation of Lord Bingham who, writing extra-judicially, held the Rule of Law to mean:[124]

> [All] persons and authorities within the state, whether public or private, should be bound by and entitled to the benefit of law publicly and prospectively promulgated and publicly administered in the court.

The Rule of Law is contrasted with 'the rule of men' and represents constraints on executive power as opposed to unfettered discretion.[125] The Rule of Law has special significance in tax law due to historical and functional purposes. Bill of Rights affirmed that "levy money for or to the use of the crown, by pretence of prerogative … is illegal".[126] This is enacted under s 22(a) of the Constitution Act 1986 which states that "It shall not be lawful for the Crown, except by or under an Act of Parliament to levy".[127] Furthermore, in contemporary society, tax structures economic behaviour. Taxpayers should be entitled to order their affairs with certainty of how tax is to be levied and be reassured that the government will not interfere with their business arrangements as long as they are within the law.

The relationship between the Rule of Law and the exercise of discretion has always been conflicted. This is especially so in the context of the reconstructive provision. Ordinary discretion conferred by Parliament only limits to the application of the law and not the assessment of the facts. This was explained by Lord Bingham, who stated:[128]

> An assessment of facts may of course be necessary and will depend on the effect made by the evidence on the mind of the decision-maker. The assessment made may be correct or it may not, but if the evidence leads the decision-maker to one conclusion he has no discretion to reach another, any more than a historian has a discretion to conclude that King John did not execute Magna Carta at Runnymede in June 1215 when all evidence shows that he did.

However, the effect of s BG 1 is that the tax avoiding arrangement is void as against the Commissioner. The annihilating effect destroys factual assessment of what actually happened. Furthermore, the reconstruction provision asks what would have happened but for the tax avoidance transaction. This creates a legal paradox between the Rule of Law and the discretion to reconstruct.

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[124] Lord Bingham "The Rule of Law" (2007) 66(1) CLJ 67 at 69.
[125] Joseph Raz "The Rule of Law and its Virtue" (1977) 93 L.Q.R. 195.
[126] Bill of Rights 1688 (Eng) 1 Will and Mar, c 2, s 1.
[127] Constitution Act 1986, s 22(a).
[128] Lord Bingham, above n 124, at 72.

In order to mitigate this paradox, this dissertation argues that the Commissioner must reconstruct in accordance with what the taxpayer has done and not what the taxpayer would have done. This was affirmed in *Miller* where the Privy Council held that reconstruction is not to rewrite history.[129] This attribute in the Rule of Law is what makes the decision in *Alesco* very uncomfortable. In refusing to reinstate any legitimate tax advantage, the Court of Appeal and the Commissioner were essentially exercising a discretion based on an assessment of facts and not on the application of the law.

Leaving the paradox to one side, even a discretion in the application of the law has always posed difficulties with the Rule of Law. As Lord Bingham stated:[130]

> The broader and more loosely-textured a discretion is, whether conferred on an official or a judge, the greater the scope for subjectivity and hence for arbitrariness, which is the antithesis of the rule of law. This sub- rule requires that a discretion should ordinarily be narrowly defined and its exercise capable of reasoned justification.

An executive power that confers discretion to the extent that allows subjectivity and arbitrariness also infringes on the constitutional principle of the Separation of Powers and Parliamentary Sovereignty. *Fitzgerald v Muldoon*[131] confirmed that strict compliance "that the pretended power of suspending the law or the execution of laws by regal authority without consent of Parliament is illegal."[132] It is for this reason that taxpayers being required to pay what they owe *but nothing more* has long been the mantra of tax law. It is therefore inappropriate that the courts' interpretation has given such unconstrained discretion to the Commissioner.

However, it is also recognised that discretion is required for flexibility. Executive discretion is required to accommodate the rigid rules that are inadequate to apply in all possible circumstances. Legislatures are unable to lay down in advance a set of rules that can adequately cover all situations.[133] This is especially important in the area of tax avoidance when we look at substance over form. The facts of each case may be complex and fact specific.

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[129] *Miller v Commissioner of Inland Revenue*, above n 44, at [22].
[130] Lord Bingham, above n 124, at 72.
[131] *Fitzgerald v Muldoon* [1976] 2 NZLR 615 at 622.
[132] Bill of Rights 1688 (Eng) 1 Will and Mar, c 2, s 1, art 1.
[133] JF Burrows and RI Carter *Statute Law in New Zealand* (5th ed, Wellington, Lexis Nexis NZ ltd, 2015) at 535.

3.2 Traditional approaches to constrain administrative discretions

In order to achieve the balance between the need for flexibility in tax administration and the risk of the discretion exceeding its constitutional scope, the courts have traditionally taken a narrow interpretation to tax legislation. Writing extra-judicially, Ivor Richardson (as he then was) notes that taxation was once seen as 'encroaching on rights and as derogating from the law."[134] Richardson quoted an English case in 1944 which held:[135]

> I do not think that any taxing Act should be construed generously; it should be construed strictly. From the very foundation of the courts of common law at Westminster it has always been the duty of His Majesty's judges to protect the subject from exactions by the Crown.

However, there has been a significant shift in the interpretive approach of tax statutes. The courts have now emphasised the neutral approach in interpreting tax statute by its text in light of its purpose.[136] Writing extra-judicially, Susan Glazebrook summarised the complexity of tax avoidance to "established statutory interpretation techniques" of interpreting the text in light of its purpose.[137]

3.3 Rule of Law issues with the current application of section GA 1

The contemporary approach of neutral interpretation has led to broad powers conferred to the Commissioner. However, as predicted by Lord Bingham, broad and loosely-textured discretion has led to subjectivity and arbitrariness. The problems identified in chapter two have also given rise to issues of uncertainty, inconsistency, and lack of accountability against the Commissioner.

First, as established in chapter two, the interpretation of s GA 1 is inconsistent in terms of when and how the provision is to operate, and also the requirement of constructing hypothetical counterfactuals to assess the illegitimate tax advantage. In *Penny & Hooper,* recognising economic substance and a legitimate tax base was not an issue for the Commissioner. However, in *Alesco,* the Commissioner disallowed the entire arrangement, despite there being a legitimate business

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[134] Ivor LM Richardson "Appellate Court Responsibilities and Tax Avoidance" (1985) 2 Austl. Tax F. 3 at 4.
[135] *Mosley v George Wimpey & Co Ltd* [1944] 2 All ER 135 at 137.
[136] *Ben Nevis v Commissioner of Inland Revenue*, above n 2, at [3].
[137] Susan Glazebrook "Statutory Interpretation, tax avoidance and the Supreme Court: reconciling the specific and the general" (Paper presented at the New Zealand Institute of Chartered Accountants 2013 Tax Conference, 18 December 2013).

purpose. This inconsistent application of the law is an infringement on all taxpayers being treated fairly and equally under the law.[138] Inconsistent application of the reconstruction provision also threatens the integrity of the tax administration.

Secondly, the inconsistent application of the law has led to uncertainty in relation to the reconstruction provision. Certainty has long been a pivotal value in tax law. As Adam Smith in *Wealth of the Nation,* once stated:[139]

> The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quality to be paid, ought all to be clear and plaint to the contributor, and to every other person.

The controversial rewrite (or amendment) of the reconstruction provision has led to confusion as to the scope of the Commissioner's powers. When and how the Commissioner is to reconstruct the transaction remains unpredictable due to the conflicting authorities and developments in the reconstruction provision.

To the Commissioner's credit, the Interpretive Statement published in 2013 greatly assisted in the interpretation of the reconstruction provision. As discussed in chapter two, the interpretive statement illustrated how the Commissioner foresaw the operation of the reconstruction provision. However, the Interpretive Statement mostly describes and summarises the current status quo of the reconstruction provision. The Interpretive Statement was influenced by the Court of Appeal's decision in *Alesco*, which has potentially set a dangerous precedent in the operation of the reconstruction provision.

Thirdly, the Commissioner's broad discretionary power means that it is difficult for her to be held accountable. It is undeniable that the cards are stacked against the taxpayer once the Commissioner alleges tax avoidance. The onus of proof is on the taxpayer to demonstrate that the Commissioner is at fault in the exercise of her discretion. As demonstrated in *Alesco,* this onus is near impossible to satisfy, especially with the wide interpretation of s GA 1. Therefore, despite flaws and inconsistencies in the application of the reconstruction provision, the taxpayer is unable to hold the Commissioner accountable.

There may also be policy arguments in favour of allowing the Commissioner broad discretion in reconstruction. Under s 6A of the TAA 1994, the Commissioner is "charged with the care and

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[138] Tax Administration Act 1994, s 6.
[139] Adam Smith *An Inquiry into the Nature and Causes of the Wealth of Nations* (Book II) (David Campbell Publishers, London, 1950) at 307.

management of the taxes covered by the Inland Revenue Acts", and must "collect the highest net revenue that is practical within the law having regard to the resources available".[140] Conferring a wide discretion to the Commissioner will improve administrative efficiency and promote greater voluntary compliance by taxpayers with the Inland Revenue.

However, administrative efficiency and promoting voluntary compliance should not be prioritised at the expense of the taxpayer being treated unfairly, impartially and not according to the law. This is affirmed under s 6 of the TAA 1994 where the Commissioner has the responsibility "to use their best endeavours to protect the integrity of the tax system". Conferring an unconstrained discretion to the Commissioner creates the risk of the Courts applying s GA 1 arbitrarily, which undermines the taxpayers' perception of the tax system's integrity and risks the law being applied unfairly.

3.4 Recommendation: a principled approach to the application of section GA 1

In order to overcome these constitutional issues while preserving the discretion required for the Commissioner, the reconstruction provision should be applied in a principled manner. Currently, the reconstruction provision is applied on an ad hoc basis. When tax avoidance cases come before the Courts, the legal arguments relating to the issue of reconstruction are ignored or only very briefly mentioned. In *Ben Nevis,* out of the 219 paragraphs delivered by the Supreme Court, only three discussed how the Commissioner should go about reconstructing the transaction. Even then, the Court only repeated the words in statute without giving much interpretation or analysis in the operation of the discretion.[141] The most discussion we have on reconstruction in recent tax avoidance cases is found in *Alesco,* which dedicates 12 out of 152 paragraphs to the issue of reconstruction. Judges and lawyers are often intellectually exhausted after analysing the complexity of tax avoidance, meaning that they have paid insufficient attention to the aftermath of reconstructing the arrangement and imposing penalties. Decisions being made on an ad hoc basis threatens the integrity of the tax system.

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[140] Tax Administration Act 1994, ss 6A(2) and 6A(3)(a).
[141] *Ben Nevis v Commissioner of Inland Revenue*, above n 2, at [169]-[171].

Parliament or the court must consider developing coherent principles to ensure that the law is applied in a consistent and predictable manner. While the Interpretive Statement has indicated that reconstruction is exercised in order to counteract any illegitimate tax advantage; reinstate legitimate tax outcomes and/or adjust any appropriate tax consequences; this only describes the effect in the exercise of the discretion. A principle is an operative legislative rule that specifies the outcome rather than the mechanism that achieves it. Coherent principles are best when they are able to capture the essence of the intended outcome in order to help the reader to make sense of the law and are intuitive or obvious to someone who understands the law's context.[142]

The most straightforward principle that deserves statutory recognition is located in s BG 1(4). Instead of allowing the Commissioner a discretion to consider what the taxpayer would have had; or would in all likelihood have had; or might be expected to have but for entering the tax avoiding arrangement; we require the Commissioner to reconstruct with the ultimate objective of achieving those factors. This reaches a compromise between allowing flexibility in the Commissioner's discretion and giving certainty to the taxpayer.

[142] Greg Pinder "The coherent principles approach to tax law design" Australia Treasury *Treasury Economic Roundup* <www.treasury.gov.au>.

Chapter Four:

Jurisdictional Comparison

This chapter will compare and contrast the reconstruction provisions in New Zealand Australia and Canada. New Zealand is out of step with both commonwealth jurisdictions. Firstly, in both Australia and Canada, a definition of 'tax advantage' has been provided in their respective income tax acts. This has significantly narrowed the scope of the Commissioner's power to reconstruct. Secondly, in both jurisdictions, case law has affirmed the use of hypothetical counterfactuals as a benchmark to assess tax liability.

Another feature of both Australia and Canada's GAAR regime is the establishment of a review board for the application of the GAAR. This review board consists of independent internal and external experts who advises the respective tax administrators and ensures consistency and integrity in the operation of the GAAR. This chapter advocates for New Zealand to follow the Australian model, especially in establishing a review board for the operation of GAAR.

4.1 Australia

The history of Australia's reconstruction provision runs parallel to New Zealand's. Similar to New Zealand's original s 103 of LITA 1954, Australia's s 260 Tax Assessment Act 1980 also annihilates any tax consequence. Around the same time that *Mangin* reached the New Zealand Privy Council, Australia encountered the same issues in *Peate v Federal Commissioner of Inland Revenue*[143]. However, Australia's response to the weakness of the original GAAR and the reconstruction provision was different to New Zealand.

Australia replaced s 260 with Part IVA of the Tax Assessment Act.[144] The reconstruction provision is located in s 177F, which gives a specific list of methods in which the Commissioner

[143] *Peate v Commissioner of Taxation of Commonwealth of Australia* (1962-1964) 111 CLR 443.
[144] Income Tax Assessment Act 1938 (Cth), pt IVA.

may reconstruct when a 'tax benefit' has been obtained.[145] In order for s 177F to apply, four elements must be satisfied:[146]

(i) A 'tax benefit' was or would, *but for* subsection 177F(1), have been obtained.

(ii) The tax benefit was or would have been obtained in connection with a scheme as defined in section 177A; and

(iii) Having regard to section 177D, the scheme is one to which Part IVA applies

While this chapter does not endeavour to provide a comprehensive review of the differences in the laws of tax avoidance and reconstruction in New Zealand and Australia, this dissertation will highlight the weaknesses of New Zealand's reconstruction provision.

First, Australia's current GAAR does not automatically void a tax avoiding arrangements. Rather, any arrangement that is caught by their GAAR provision gives the Commissioner the discretion to adjust the tax benefit that has been obtained. Removing the voiding effect of the GAAR has two benefits. First, the Commissioner is required to exercise the power of reconstruction every time a transaction avoids tax. This will prevent situations such as *Alesco* where the Court held that the Commissioner has the discretion not to reconstruct at all. Furthermore, the perceived paradox between the Rule of Law and a discretion in the assessment of fact will not be an issue.

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[145] Income Tax Assessment Act 1936 (Cth), s177F states that:
(1) where this Part applies to a scheme in connection with which a tax benefit has been obtained, or would but for this section be obtained, the Commissioner may:

(a) In the case of a tax benefit that is referable to an amount not being included in the assessable income of the taxpayer of a year of income- determine that the whole or a part of that amount shall be included in the assessable income of the taxpayer of that year of income; or
(b) In the case of a tax benefit that is referable to a deduction or a part of a deduction being allowable to the taxpayer in relation to a year of income- determine that the whole or a part of the deduction, as the case may be, shall not be allowable to the taxpayer in relation to that year of income; or
(c) In the case of a tax benefit that is referable to a capital loss or a part of a capital loss being incurred by the taxpayer during a year of income- determine that the whole or a part of the capital loss or of the part of the capital loss, as the case may be, was not incurred by the taxpayer during the year of the income; or
(d) In the case of a tax benefit that is referable to a foreign income tax offset, or a part of a foreign income tax offset, being allowable to the taxpayer- determine that that the whole or a part of the foreign income tax offset, or the part of the foreign income tax offset, as the case may be, is not to be allowable to the taxpayer; or
(e) In the case of a tax benefit that is referable to an exploration credit, or a part of an exploration credit, being issued to the taxpayer- determine that
    (i) The whole or a part of an exploration development incentive tax offset that would otherwise be allowable to the taxpayer in relation to the exploration credit, or the part of the exploration credit, as the case may be, is not to be allowable to the taxpayer; or
    (ii) The whole or a part of a franking credit that would otherwise arise in the franking account of the taxpayer in relation to the exploration credit, or the part of the exploration credit, as the case may be, is not to arise in the franking account of the taxpayer;

and where the Commissioner makes such a determination, he or she shall take such action as he or she considers necessary to give effect to the determination.

[146] "Application of General Anti-Avoidance Rules" (Australian Taxation Office, PS LA 2005/24, September 2005) ('Australian Practice Statement') at [47].

The discretion conferred under s 177F does not require restructuring the original transaction but simply tax income that was not included or disallow deductions of expenses, foreign credit or capital loss where it is held to be tax avoidance.

Secondly, the term 'tax benefit' in Australia encompasses both 'tax avoidance' and 'tax advantage' in New Zealand. As noted, a quantum of tax benefit must first be identified for the GAAR to apply. Tax benefit is defined under s 177C(1) as:[147]

(i) An amount not being included in the assessable income of the taxpayer of a year of income;
(ii) A deduction being allowable to the taxpayer in relation to a year of income
(iii) A capital loss being incurred by the taxpayer during a year of income
(iv) A foreign tax credit being allowable to the taxpayer

The definition of 'tax benefit' shares similarities to New Zealand's definition of 'tax avoidance'. Both definitions give examples of altering the incidence of tax. However, what is interesting under the Australian regime is that once the "tax benefit" is identified, it is also the same "tax benefit" that is counteracted by s 177F. This ensures the tax benefit obtained under the tax avoidance arrangement is also the tax benefit counteracted during reconstruction.

This contrasts with New Zealand where there are two different terminologies. Section BG 1 states that every 'tax avoidance' arrangement is void against the Commissioner. However, in s GA 1(2), the Commissioner has a duty to counteract the 'tax advantage'. The Income Tax Act 2007 only provides a definition for tax avoidance and not tax advantage. As discussed in chapter two, s GA 1 also fails to link the tax advantage obtained in the tax avoidance arrangement to the tax advantage counteracted in the reconstruction provision. This has led to instances where reconstruction has failed to reinstate legitimate tax outcomes.

Furthermore, a tax benefit can only be obtained *but for* the Australian GAAR. Due to the 'but for' test expressed under section 177F, the Commissioner is required to construct a hypothetical counterfactual. In *Federal Commissioner of Taxation v Peabody,* the High Court of Australia has incorporated a 'reasonable expectation' test in reconstructing an alternative hypothesis.[148] The Australian Practice Statement has listed a non-exhaustive list of how the Commissioner will identify counterfactuals, being:[149]

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[147] Income Tax Assessment Act 1936 (Cth), s 177C(1).
[148] *Federal Commissioner of Taxation v Peabody* (1994) 28 ATR 344.
[149] Australian Practice Statement, above n 146, at [74].

- The most straightforward and usual way of achieving the commercial and practical outcome of the scheme (disregarding the tax benefit)
- Commercial norms, for example, standard industry behaviour;
- Social norms, for example, family obligations
- Behaviour of relevant parties before/ after the scheme compared with the period of operation of the scheme; and
- The actual cash flow

This provides a stark contrast between the development of New Zealand and Australia case law. In Australia, a hypothetical counterfactual must first be constructed in order for the GAAR to apply and the tax benefit to be counteracted. The list of factors in which the ATO considers also aids the consistency, transparency and certainty of the GAAR.

It is interesting to note that counsel for *Alesco* attempted to adopt the Australian approach of requiring a tax advantage to exist in order for the GAAR to apply. Alesco NZ submitted that the 'quantitative assessment' of the tax advantage must be identified in order to establish a tax avoiding transaction.[150] Therefore, no tax avoidance arrangement existed because a counterfactual scenario using an interest bearing loan would have yielded greater deductions for Alesco NZ than the OCNs. However, the Court of Appeal rejected the submission by the taxpayer, holding that:[151]

> The question is whether the particular arrangement had the effect of avoiding or reducing any liability to income tax. It is not whether Alesco NZ would have been equally able to avoid or reduce its liability by implementing an alternative and permissible arrangement.

The Court of Appeal was correct in applying the three step test in *Ben Nevis*. While this is outside the scope of this dissertation, New Zealand may need to reconsider whether legislative amendments are required to be more consistent with other Common Law jurisdictions and in the interests of the certainty and clarity of the NZ GAAR.

The requirement by the Australian Federal Commissioner to construct a hypothetical scenario is controversial. In *RCI PTY Ltd v Federal Commissioner of Taxation,* the taxpayer submitted argued that a number of different restructuring options were considered, each achieving different commercial benefits. However, the Commissioner refused to reconstruct on the basis of the

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[150] *Alesco New Zealand Ltd v Commissioner of Inland Revenue*, above n 77, at [34].
[151] At [39].

taxpayer's alternative options, arguing that all that is required is for the reconstruction to be reasonable. The Full Federal Court ruled in favour of the taxpayer, holding that:[152]

> [The taxpayer] has not established that the Commissioner's counterfactual is unreasonable, but that is not the statutory question…. The statutory question in one for objective enquiry and determination - what the taxpayer might reasonably be expected to have done if it had not entered into the scheme.

Writing extra-judicially, Pagone criticised the approach of requiring a comparison between what was actually done with an alternative hypothesis of what the taxpayer would otherwise actually have done if the taxpayer had not entered the scheme.[153] Pagone argues that this has resulted in unnecessary "mental gymnastics" which undermines the purpose of GAAR.[154]

In addition to the more coherent and principled manner in how Australia approaches Part IVA, their establishment of a 'GAAR panel' is highly commendable. The Practice Statement stated:[155]

> The primary purpose of the Panel is to assist the Tax Office in its administration of the GAAR in the sense that decisions made on the application of GAAR is objectively based and there is a consistency in approach to various issues that arise from time to time in the application of the GAARs. The Panel does this by providing independent advice to a GAAR decision maker in those matters which are referred to it. This includes advice regarding the appropriate imposition of penalties.

The Panel provides an internal safeguard to the application of GAAR by cases seeking to invoke the GAAR.[156] While the Panel is purely consultative, it provides a level of transparency as well as consistency, accountability and compliance with the law. The GAAR panel usually consists of three internal members of the ATO and three external members with expertise in their field. Allowing external members on the GAAR panel promotes public confidence by ensuring external review and accountability. Furthermore, expertise on the panel allows better understanding of technical economic concepts that are often not the specialty of judges and lawyers. This is a significant benefit to the application of the GAAR and the reconstruction of the arrangement.

The only shortcoming of the Panel identified by Pagone identified is the appointment process of the external members.[157] GAAR panel members are appointed by the Commissioner for an

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[152] *RCI Pty Ltd v Federal Commissioner of Taxation* (2011) 20 ATC 275 at [140].
[153] Tony Pagone, above n 104, at 41.
[154] Tony Pagone, above n 104, at 41.
[155] Australian Practice Statement, above n 45, at [23].
[156] GT Pagone "Parallel Tax Avoidance Provisions: Australia and New Zealand" (speech to Tax Conference, Wellington, 27 October 2012) at 32.
[157] At 32.

unspecified term, which may reduce public confidence. Pagone recommends that GAAR members should not have the ability to choose the panel and allow to terminate their service at will. However, this does not detract from the professionalism demonstrated by panel members.

4.2 Canada

Canada's GAAR provision was enacted in 1987, 6 years after Australia's amendment to their GAAR provision. Learning their lesson from Australia, the reconstruction provision for Canada was very similar to Australia. Section 245(2) states that[158]

> Where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for this section, would result directly or indirectly, from that transaction or from a series of transaction that includes that transaction.

In the Canadian leading decision of *Canada Trusco Mortgage Co v Canada,* the Supreme Court held that three requirements, must be established to permit the application of GAAR:[159]

(1) A tax benefit resulting from a transaction or part of a series of transactions
(2) That the transaction is an avoidance in the sense that it cannot be said to have been reasonably undertaken or arranged primarily for a *bona fide* purpose other than to obtain a tax benefit; and
(3) That there was abusive tax avoidance transaction in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provision relied upon by the taxpayer.

The Act provides a definition of 'tax benefit' as follows:[160]

> A reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act, and includes a reduction, avoidance or deferral of tax or other amount that would be payable under this Act but for a tax treaty or an increase in a refund of tax or other amount under this Act as a result of a tax treaty.

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[158] Income Tax Act RSC 1985 c 1, s 245(2).
[159] *Canada Trustco Mortgage Co v Canada* 2005 DTC 5523 (SCC) at [17].
[160] Income Tax Act RSC 1985 c1, s 245(1).

Similar to Australia, the term 'tax benefit' also carries out the functions of both 'tax avoidance' and 'tax advantage' in New Zealand. Further, in order for GAAR to apply, the CRA must first identify the tax benefit obtained by the taxpayer. The *Canada Trustco,* the Supreme Court made the following comment in determining whether a tax benefit existed:[161]

> If a reduction against taxable income is claimed, the existence of a tax benefit is clear, since a deduction result in a reduction of tax. In some other instances, it may be that the existence of a tax benefit can only be established by comparison with an alternative arrangement. For example, characterisation of an amount as an annuity rather than as a wage, or as a capital gain rather than as business income, will result in differential tax treatment. In such cases, the existence of a tax benefit might only be established upon a comparison between alternative arrangements. In all cases, it must be determined whether the taxpayer reduced, avoided or deferred tax payable under the Act.

The statement by the Supreme Court has distinguished between income avoidance cases and deduction avoidance cases. It is therefore unclear whether situations like *Alesco* will be treated any differently in Canada. However, as tax advantage needs to be demonstrated "in all cases", there are potential grounds for the Court to require a hypothetical scenario where tax avoidance involves deductions. This was confirmed in *McNichol et al v the Queen,* where it was held that:[162]

> There is nothing mysterious about the subsection 245(1) concept of tax benefit. Clearly a reduction or avoidance of tax does require the identification in any given set of circumstances of a norm or standard against which reduction is to be measured.

However, where there is more than one way in which the taxpayer could have arranged their affairs, the CRA could presumably measure the tax benefit by reference to the high tax cost of the alternative which the taxpayer did not undertake. While the existence of tax benefit was not an issue in *Canada Trustco,* the Supreme Court stated in obiter that:

> In general, Parliament confers tax benefits under the *Income Tax Act* to promote purposes related to specific activities… the conferring of particular tax benefit can serve a variety of independent and interlocking purposes. These ranges from imposing fair business accounting principles and promoting particular kinds of commercial activity to providing family and social benefits.

The statement by the Canadian Supreme Court bears resemblance to the Parliamentary contemplation test of *Ben Nevis.*[163] However, unlike the New Zealand approach, Canada has

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[161] *Canadian Trstco Mortgage Co v Canada*, above n 159, at [20].
[162] *McNichol et al v The Queen* 97 DTC 111 (TCC) at 119.
[163] *Ben Nevis v Commissioner of Inland revenue,* above n 2, at [107].

emphasised the importance of certainty and predictability of tax law. The Supreme Court also held:

> Despite Parliament's intention to address abusive tax avoidance by enacting the GAAR, Parliament nonetheless intended to preserve predictability, certainty and fairness in Canadian tax law. Parliament intends taxpayers to take full advantage of the provisions of *Income Tax Act* that confer tax benefits. Indeed, aching the various policies that the *Income Tax Act* seeks to promote is dependent on taxpayers doing so.

Once it is determined that the GAAR applies, s 245(5) gives a non-exhaustive list of how adjustment is to be carried out.[164]

However, the Canadian approach may have gone too far in protecting a taxpayer's right to mitigate tax at the expense of an effective GAAR provision. An effective GAAR has the benefit of protecting the integrity of the tax system and ensuring that all taxpayers are paying their fair share.[165] It is also economically inefficient for taxpayers to invest time and money looking for tax loopholes instead of engaging in productive economic activity.[166]

When the Valabh Committee recommended the legislative rewrite, it also made recommendations on New Zealand's tax avoidance provision. The recommendation given by the Valabh Committee shares significant similarity with s 245(5) of Canada's Income Tax Act.[167] While the Valabh Committee rejected the Canadian approach in requiring 'abusive' tax avoidance, it advocated to follow Australia approach in adopting a 'but for' test and defining 'income tax advantage'. Therefore, while the Committee recommended the Commissioner's

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[164] Income Tax Act RSC 1985 c 1, s 245(5) states:
Without restricting the generality of subsection (2), and notwithstanding any other enactment:

(a) any deduction, exemption or exclusion in computing income, taxable income, taxable income earned in Canada or tax payable or any part thereof may be allowed or disallowed in whole or in part,
(b) any such deduction, exemption or exclusion, any income, loss or other amount or part thereof may be allocated to any person,
(c) the nature of any payment or other amount may be recharactersied; and
(d) the tax effects that would otherwise result from the application of other provisions of this Act may be ignored,

in determining the tax consequence to a person as is reasonable in the circumstances in order to deny a tax benefit that would, but for this section, result directly or indirectly, from an avoidance transaction.

[165] Julie Cassidy "The Holy Grail: The Search for the Optimal GAAR" (2009) 126 S African LJ 740 at 740.

[166] At 740.

[167] Valabh Committee, above n 48, at 30 recommended the reconstruction provision to be worded as follows:
s 99(6) Where there is a tax avoidance arrangement, the Commissioner may take such steps as are reasonable in the circumstances to counteract any income tax advantage of the taxpayer as a result of that arrangement, and-

(a) ignore, adjust or recharacterise the nature or the terms of any tax avoidance arrangement; and
(b) … issue or amend assessment or determinations of loss.

Cf Income Tax Act RSC 1985 c 1, s 245(5), above n 164.

power to reconstruct be discretionary, it would be limited and be exercised in a way so as to only remove illegitimate tax advantage.

The GAAR assessment process in Canada mirrors features of the Australian GAAR panel and New Zealand's tax dispute resolution process. There are many hurdles for CRA to jump through in order for GAAR to apply. The process begins with the Tax Service Office ('TSO') investigating possible abusive tax avoidance schemes.[168] Once the TSO decides that the GAAR applies and wishes to reassess the taxpayer's liability, the TSO must refer the case to the CRA headquarters. The headquarters will then carry out its own review on whether the GAAR should be assessed in the specific situation.[169] If the CRA agrees there was abusive tax avoidance, it will then refer to the 'GAAR and Technical Support' where an auditor will be assigned to the case. The auditor will then refer and present the case to the 'GAAR committee'.[170] While taxpayers are not entitled to appear in front of the committee, they are allowed to file written submissions and meet with CRA members of the Committee beforehand.[171]

The GAAR committee is a hybrid between an advisory board and a tribunal. The committee only has an advisory role and there are not legal requirements for the CRA to follow the advice given.[172] However, convention dictates their advice is normally followed.[173] The committee consists of internal senior representatives of Income Tax Rulings, Legislative Policy, Department of Finance lawyers and representatives of the tax policy branch. The taxpayer may request a copy of the minutes of the GAAR committee's decision.[174] If the CRA refuses to release the minutes, the taxpayer may obtain them through an information request or as part of the litigation discovery process.[175]

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[168] William I Innes, Patrick J Boyle and Joel A Nitikman *The Essential GAAR Manual: Policies, Principle and Procedure* (CCH Canadian Ltd, Toronto, 2006) at 91.
[169] At 91.
[170] At 91.
[171] At 91.
[172] At 91.
[173] At 93.
[174] At 90.
[175] At 91.

4.3 Recommendations from comparison with Australia and Canada

New Zealand should follow the approach of Australian and Canada in providing a definition for 'tax advantage'. While the identification of tax advantage is a perquisite in the application of GAAR in Australia and Canada, this is outside the scope of this dissertation and should therefore be discussed another day.

This dissertation highly recommends New Zealand establishes a GAAR advisory board. The GAAR Panel in Australia and the GAAR Committee in Canada have provided great assistance to the operation and application of their tax avoidance regimes. A GAAR advisory board would aid in the consistency and integrity of New Zealand's tax administration. The GAAR advisory board may also provide expertise on economic concepts that lawyers and judges may not fully understand.

Conclusion

The lack of intellectual investment in the aftermath of applying the GAAR has demonstrated problems in principle and in practice. These problems will inevitably resurface as the Commissioner invokes the GAAR more frequently in the future. The purpose of this dissertation was therefore to consider these problems and provide pragmatic solutions to the law on the reconstruction provision.

The original reconstruction provision was enacted to allow the Commissioner the power to reconstruct an arrangement where the voiding effect of the GAAR did not automatically provide an assessment. The Ross Committee contemplated the operation of the reconstruction provision would require the Commissioner to construct a hypothetical benchmark. However, the unintended amendment in 1995, coupled with the courts' broad interpretation, has led to inconsistent and unprincipled application. The most problematic case identified in this dissertation was *Alesco*. It illustrated a significant shift in the Court's approach in not considering the economic substance of the arrangement.

The problems identified also infringed on the fundamental principles of Rule of Law and Separation of Powers. The Rule of Law dictates that all men are under the law and governed in accordance with the law. While this dissertation concedes that a discretion is required, this should not be unconstrained. The wide interpretation of s GA 1 has led to inconsistency, uncertainty and lack of accountability.

In order to resolve the issues identified, this dissertation has provided three major recommendations. First, a definition of 'tax advantage' is required in the Act to narrow the scope of the Commissioner's discretion. By specifying 'tax advantage' to tax arisen out of the tax avoidance arrangement, the Commissioner will only be able to void illegitimate tax advantage and be required to reinstate legitimate tax advantages.

Second, the reconstruction discretion should be exercised on a principled basis. Tax avoidance cases have always focused on the question of whether there was tax avoidance. Judges and lawyers are intellectually exhausted before they reach the stage of considering what happens after the application of GAAR. The reconstruction provision has therefore always been applied on an ad hoc basis, which threatens the consistency and certainty of tax administration. A principled basis therefore must be developed by either Parliament to guide the exercise of the discretion. The most straightforward way identified by this dissertation was to make s GA 1(4) a principle

and not a discretion. The ultimate goal of reconstruction should be what the taxpayer would have paid but for the tax avoiding arrangement. Having this as a guideline will direct the Commissioner on how the power is to be exercised.

Third, a GAAR committee in overseas jurisdictions has demonstrated invaluable benefits to the application of the GAAR and the reconstruction. As Pagone pointed out, lawyers and Judges may not be have the specialisation of understanding complicated commercial arrangements. This has led to some reconstruct been unfairly punitive on the taxpayer. A GAAR committee would therefore be greatly beneficial in aiding the Commissioner to apply the GAAR.

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