

“Paying what you have to and not a penny more”

Does the “parliamentary contemplation” test provide a justifiable level of certainty in the law on tax avoidance? – With a focus on the use of company/trust structures

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INTRODUCTION

This dissertation examines the law on tax avoidance in New Zealand, and in particular, provides a critical analysis of the Supreme Court's approach to reconciling the use of specific statutory provisions in the Income Tax Act 2007 with the general anti-avoidance provision ("GAAR").¹ This approach is known as the "parliamentary contemplation" test, which was formulated by the Supreme Court in *Ben Nevis Forestry Ventures Ltd and Ors v Commissioner of Inland Revenue*.² This approach was subsequently applied by the Supreme Court in *Penny and Hooper v Commissioner of Inland Revenue*.³

This analysis will address the key issue of whether the "parliamentary contemplation" test provides a justifiable level of certainty for taxpayers. A commonly expressed viewpoint on tax is that people want to "pay what they have to and not a penny more",⁴ so desire guidance on how they can they can legitimately reduce their tax burden. Some commentators have contended that the introduction of the "parliamentary contemplation" test has led to increased uncertainty in this area of law.⁵

This dissertation is of the view that concerns about uncertainty are overstated and that the value of certainty should not be a crucial factor in assessing the "parliamentary contemplation" test. While there is a need to provide taxpayers with guidance, uncertainty is an inevitable product of what is a difficult and complicated area of law, no matter what approach is taken. Furthermore, uncertainty is necessary to ensure that the GAAR can effectively counter tax avoidance and provide a deterrent effect against aggressive tax planning. The "parliamentary contemplation" test can be justified on the grounds that it represents an improvement over

¹ Income Tax Act 2007, s BG 1.

² *Ben Nevis Forestry Ventures Ltd and Ors v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289.

³ *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 62, [2012] 1 NZLR 433.

⁴ The title of this dissertation was inspired by British comedian Jimmy Carr, who expressed this sentiment whilst being in the media spotlight for his participation in a tax avoidance scheme. See "Jimmy Carr tax affairs 'morally wrong' - Cameron" (20 June 2012) BBC News <<http://www.bbc.co.uk/news/uk-politics-18521468>>. This view stems from the "choice principle" expressed by Lord Tomlin in *The Commissioners of Inland Revenue v The Duke of Westminster* [1936] AC 1 (HL) at 19-20, who stated that "[e]very man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Act is less than it otherwise would be".

⁵ Craig Eliffe and Jess Cameron "The Text for Tax Avoidance in New Zealand: A Judicial Sea Change" (2010) 16 NZBLQ 440 at 458-459; Eugen Trombitas "The Conceptual Approach to Tax Avoidance in the 21st Century: When the Statute Gives But the GAAR Can Take Away" (2009) 15 NZJTL 352 at 365-366, 377, 387; Kirsty Keating "Reform of the general anti-avoidance provision - the iron is hot" [2011] (6) CCH NZ Tax Planning Reports at 2-4; Taxation Committee of the New Zealand Law Society, Corporate Taxpayers Group and Taxation Committee of the New Zealand Institute of Chartered Accountants *Improving the Operation of New Zealand's Tax Avoidance Laws* (October 2011) at 9-10.

previous approaches to tax avoidance. While this test does not necessarily provide a greater degree of certainty, this is not strictly a desirable or achievable aim in this context.

Chapter One explains why tax avoidance is problematic and how Parliament has chosen to deal with it by enacting the GAAR. After listing the difficulties in applying the GAAR, this chapter will look at how the courts have reconciled the use of specific statutory provisions with the GAAR. This involves an examination of the “scheme and purpose” approach stated by Richardson J in *Challenge Corporation v Commissioner of Inland Revenue*,⁶ and the “parliamentary contemplation” test. This chapter will conclude by considering whether this new approach represents a change in the underlying approach on tax avoidance.

Chapter Two will critically analyse the “parliamentary contemplation” test, questioning whether it provides a justifiable level of certainty in this area of law. This chapter will address why certainty is important, and how the application of the “parliamentary contemplation” test leaves a degree of uncertainty in the law. This chapter will explain how concerns about uncertainty can be mitigated to some degree, demonstrate why tax avoidance is an inherently uncertain concept, and compare the concept of tax avoidance to vague standards in other areas of law. This chapter will conclude by demonstrating why certainty should not be the paramount consideration in the law on tax avoidance.

Chapter Three focuses on the application of the “parliamentary contemplation” test in the Supreme Court’s decision in *Penny and Hooper*. In this case, each taxpayer transferred their orthopaedic practice to a company owned by their family trust. Salaries were paid to the taxpayers at below arms-length levels, and remaining company profits were distributed to the family trust. This produced a tax advantage as the majority of profit generated by each practice was taxed at the trustee rate of 33%, rather than the top marginal income tax rate of 39%. This case is different to *Ben Nevis* as the tax advantage arose through the structures which the taxpayers employed, rather than through the utilisation of a specific statutory provision. This chapter examines key elements of the Supreme Court’s decision which led to a finding of tax avoidance. These were the absence of a commercially realistic salary, lack of reasons to justify paying a lower salary, and the fact that the taxpayers retained the benefits of the use of funds generated by their practices. This chapter will conclude by applying the discussion about certainty from Chapter Two to the guidance given by the Supreme Court in this case, to determine whether a sufficient level of certainty is provided in this context.

⁶ *Challenge Corporation v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA)

CHAPTER ONE: THE CURRENT APPROACH TO TAX AVOIDANCE IN NEW ZEALAND

1. What is tax avoidance and why is it a problem?

Put simply, tax avoidance occurs when the taxpayer has gained tax savings through complying with all applicable statutory provisions, but the policy of the law conflicts with the taxpayer's use of those statutory provisions and asserts that tax should be paid or not reduced.⁷ By contrast, tax evasion is where Inland Revenue is not informed of all the information relevant to an assessment of tax.⁸ Examples of tax evasion include when a taxpayer unjustly claims a deduction or obtains a tax refund which they are not entitled to.⁹

Tax avoidance is a problem for several reasons. If not dealt with effectively, it reduces the amount of tax which can be collected by the Government.¹⁰ Tax avoidance undermines the integrity of the tax system as it results in shifting the burden of taxation to other taxpayers.¹¹ This is because if some taxpayers can find ways of paying less tax, whilst others have less ability to do this, taxpayers will perceive the system as unfair, and will be less likely to comply voluntarily with their obligations. An even playing field is required to ensure that businesses do not have their competitiveness undermined by other firms who exploit loopholes in the law.¹² Globalisation has increased the problems in this area as taxpayers engage in schemes designed to shift the source of income from one jurisdiction to another. This provides a threat to both the revenue base and overall fairness of the tax system.¹³ Tax avoidance also damages economic efficiency when tax is a major factor in business decisions.¹⁴ The time spent by taxpayers and tax practitioners on finding loopholes in the law is a waste of time and money which could be put towards more productive purposes. This harms the efficiency of New Zealand's economy.¹⁵

⁷ Eugen Trombitas "Statutory Interpretation and Tax Avoidance" [2010] NZLJ 428 at 428.

⁸ *Challenge Corporation* (PC), above n 6, at 561, per Templeman J.

⁹ Tax Administration Act 1994, s 141E.

¹⁰ Harry Ebersohn "Tax Avoidance and the Rule of Law" (2012) 2 NZ L Rev 243 at 255-256.

¹¹ Ivor LM Richardson "Attitudes to Income Tax Avoidance" (Inaugural Address, Victoria University, Wellington, 18 April 1967) at 11.

¹² Ebersohn, above n 10, at 256-258.

¹³ Julie Cassidy "The Duke of Westminster 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 at 7.

¹⁴ Graham Aaronson *GAAR Study - A study to consider whether a general anti-avoidance rule should be introduced into the UK tax system* (11 November 2011) at 4.

¹⁵ Richardson "Attitudes to Income Tax Avoidance", above n 11, at 13.

2. The need for a GAAR

Because of the negative consequences of tax avoidance, the law needs to place limits on it. One method of preventing this behaviour is through specific anti-avoidance provisions which operate to counter particular instances where a taxpayer could otherwise gain a tax advantage.¹⁶ This cannot be the sole weapon to counter tax avoidance, as it only allows Parliament to counter the damaging effects of tax avoidance arrangements once they have been uncovered. Once new rules are enacted, taxpayers will then attempt to find further loopholes. As Aaronson notes, this results in a “fiscal game of chess, but with an ever increasing number of moves and pieces,”¹⁷ causing tax legislation to become increasingly complicated and unwieldy. Parliament cannot be expected to predict all methods of tax avoidance and enact rules to prevent these from occurring. There will always be opportunities within the statutory scheme for creative compliance with the rules to generate a tax advantage, despite the existence of anti-avoidance rules.¹⁸ Specific anti-avoidance provisions are insufficient on their own to counter tax avoidance in New Zealand.¹⁹

While the Income Tax Act does contain specific anti-avoidance provisions, Parliament has enacted the GAAR in order to protect against attacks on the revenue base.²⁰ The GAAR was recognised by Woodhouse P in *Challenge Corporation* as a key feature of our income tax legislation which reflects the intention of Parliament that there must be a method of “thwarting technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages.”²¹

¹⁶ An example of a specific anti-avoidance provision is the minor beneficiary rules located in Sections HC 35 – HC 37 of the Income Tax Act 2007. These rules deem that distributions of trust income to minor beneficiaries (persons under 16 years of age) must be taxed at the trustee rate of 33%, rather than the individual’s marginal tax rate. This rule is aimed at negating any tax advantage which would otherwise be gained by distributing trust income to a minor beneficiary (e.g. child of the family), who is likely to have a lower marginal tax rate.

¹⁷ Aaronson, above n 14, at 15.

¹⁸ Judith Freedman “Defining taxpayer responsibility: in support of a general anti avoidance principle” [2004] BTR 332 at 352-353.

¹⁹ While it is acknowledged that the United Kingdom (“UK”) has chosen to use specific anti-avoidance provisions as their primary method of countering avoidance, this dissertation is of the view that this would not be appropriate in New Zealand. This is because the Revenue Authority in the UK has other methods of targeting tax avoidance which are not used in New Zealand, such as a purposive interpretation of tax legislation which the courts in New Zealand have chosen not to adopt (See *Ben Nevis*, above n 2, at [111]). Also, the UK is currently experiencing some problems in relying upon specific anti-avoidance provisions to counter tax avoidance, as this has not always been sufficient to counter aggressive tax avoidance schemes which provide a threat to the revenue base. Because of these problems, there is currently a proposal in the UK to introduce a more restricted version of a GAAR in their income tax legislation (See Aaronson, above n 14 at 15-21).

²⁰ *BNZ Investments v Commissioner of Inland Revenue* (2000) 19 NZTC 15,732 (HC) at [52].

²¹ *Challenge Corporation (CA)*, above n 6, at 532.

This dissertation is premised on the view that an effective GAAR is necessary for the effective operation of the tax system in New Zealand. The GAAR has two main functions. The first is to supply direction to the courts to enable it to apply specific provisions in a way that is intended by Parliament.²² The second is to deter taxpayers from adopting aggressive tax schemes.²³

The GAAR is located in Section BG 1 of the Income Tax Act 2007.²⁴ This section states that “[a] tax avoidance arrangement is void as against the Commissioner”. Section YA 1 contains definitions which aid in the interpretation of s BG 1. “[T]ax avoidance arrangement” is defined as an arrangement which has tax avoidance as its purpose or effect, or one of its purposes or effects ... if the tax avoidance purpose or effect is not merely incidental”. The definition of “tax avoidance” includes “directly or indirectly altering the incidence of income tax”.

3. Difficulties in applying the GAAR

The GAAR has long been recognised as difficult to apply.²⁵ The issue of tax avoidance has occupied a large proportion of the both Inland Revenue and the courts’ time in recent years.²⁶ Trombitas notes that tax avoidance can only be found to exist under the GAAR “when the statute is held to mean something other than what it actually says”, so it can be difficult to determine whether Parliament intended the GAAR to apply in a particular scenario.²⁷ A strictly literal interpretation of the GAAR would render some transactions ineffective, when the GAAR was never intended to be aimed at the section.²⁸ As the definition of “tax

²² Judith Freedman "Interpreting tax statutes: tax avoidance and the intention of Parliament" [2007] LQR 53 at 75.

²³ Trombitas "The Conceptual Approach to Tax Avoidance in the 21st Century", above n 5, at 354.

²⁴ Both sections are located in the Appendix. For an overview of the legislative history of the GAAR in New Zealand, refer to *Ben Nevis*, above n 2, at [71]-[83].

²⁵ See Michael Littlewood "Tax Avoidance, the Rule of Law and the New Zealand Supreme Court" (2011) 1 NZ L Rev 35 at 40-46 who goes into greater detail on the difficulties in applying the GAAR, and the different approaches which have been applied to interpret it by the courts.

²⁶ A recent study undertaken by Mark Keating and Kirsty Keating found that 29% of reported tax judgments between 2001 and 2010 have dealt with tax avoidance disputes. While only 28.4% of those judgments represent substantive disputes, this still indicates that tax avoidance disputes are taking up a significant amount of the courts’ time. In addition, 19% of Inland Revenue adjudication reports over the same time period involved tax avoidance in the grounds for dispute. See Mark Keating and Kirsty Keating "Tax Avoidance in New Zealand: The Camel's Back That Refuses to Break" (2011) 17 NZJTL 115 at 120-126.

²⁷ Trombitas "The Conceptual Approach to Tax Avoidance in the 21st Century", above n 5, at 355.

²⁸ See *Commissioner of Inland Revenue v Gerard* [1974] 2 NZLR 279 (CA); (1974) 4 ATR 369 at 370, per McCarthy P; *Challenge Corporation*, above n 6 at 532, per Woodhouse P.

avoidance” in s YA 1 includes “altering the incidence of income tax”,²⁹ a literal interpretation would make it possible for any arrangement which allows a taxpayer to claim a deduction or defer payment of income tax to be classified as tax avoidance. One example is the “PIE” rules.³⁰ These allow a taxpayer to gain tax savings by depositing their money in a managed PIE fund, as the PIE tax rate is lower than the top marginal income tax rate (which applies to taxpayers who deposit money into an ordinary bank account). Utilising these rules has a purpose of tax avoidance by “indirectly altering the incidence” of tax,³¹ yet it is commonly accepted that this is not tax avoidance.³²

One major problem with the GAAR is that it does not specify the relationship between specific statutory provisions and the operation of the GAAR, and does not state whether it is legitimate to take advantage of certain provisions to avoid or reduce tax.³³ Richardson J recognised this tension in *Challenge Corporation* when he stated that “the legislature could not have intended that s 99³⁴ should override all provisions of the Act” but that “s 99 would be a dead letter if it were subordinate to all the specific provisions in the legislation.”³⁵ Subsequent amendments to the GAAR have not addressed how to reconcile the relationship between the GAAR and provisions within the Act.³⁶

As Parliament has failed to provide a workable definition of “tax avoidance”, the judiciary has developed judicial glosses on the statutory language as a way of making sense of the provision.³⁷ Because the GAAR is worded generally, Parliament has left it up to the courts to decide which arrangements the GAAR would apply to.³⁸ An example of a judicial gloss is that transactions which are “capable of explanation by reference to ordinary business or family dealing”,³⁹ are considered outside the scope of tax avoidance. Another example is

²⁹ Income Tax Act 2007, s YA 1.

³⁰ See subpart HM of the Income Tax Act 2007.

³¹ See Income Tax Act 2007, s YA 1: Definition of “tax avoidance”.

³² *Improving the Operation of New Zealand’s Tax Avoidance Laws*, above n 5, at 6-7. See also *Penny and Hooper* (SC), above n 3, at [49].

³³ *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591, (1970) 1 ATR 835 at 601, per Lord Wilberforce.

³⁴ Section 99 Income Tax Act 1976 is an earlier version of what is now s BG 1 Income Tax Act 2007.

³⁵ *Challenge Corporation* (CA), above n 6, at 548-549.

³⁶ *Ben Nevis*, above n 2, at [83].

³⁷ *Gerard*, above n 28, at 370. Littlewood “Tax Avoidance, the Rule of Law, and the New Zealand Supreme Court”, above n 25, at 42.

³⁸ *Ben Nevis* at [101].

³⁹ *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] AC 450 at 465-466. The legislature has now expressly overruled this decision by defining “tax avoidance arrangement” (s YA 1 Income Tax Act 2007) as having tax avoidance as one of its purposes or effects, “whether or not any other purpose or effect is referable to ordinary business or family dealings”, provided that the “tax avoidance purpose or effect is not merely incidental”.

describing tax avoidance as occurring when a taxpayer reduces their tax liability without suffering a loss or incurring expenditure.⁴⁰ However, the Supreme Court now warns against applying any judicial gloss to the statutory language,⁴¹ even though they have arguably applied their own judicial gloss in the form of the “parliamentary contemplation” test.⁴² The following sections examine two recent authoritative judicial approaches employed in New Zealand to reconcile the tension between the use of specific provisions and the GAAR.

4. The “scheme and purpose” approach

In *Challenge Corporation*, Challenge purchased a company which had a large amount of tax losses. Challenge utilised a specific statutory provision which allowed these losses to be offset against its profits, to reduce its tax liability. An anti-avoidance provision existed, but this only prohibited offsetting of losses when there was a temporary change in the shareholding of the company whose shares are purchased, not a permanent change (as occurred in this case).⁴³ The key issue in this case was the relationship between the GAAR and specific provisions of the Act.⁴⁴

Richardson J stated that reconciling the specific provision with the GAAR is a matter of statutory construction which rests on assessing “the scheme ... and the relative objectives of the legislation”.⁴⁵ The inquiry is aimed at understanding “whether there is room in the statutory scheme for application of the [GAAR] in the particular case” and this is done via a consideration of the historical context of the statute, the structure of the Act, relationships between different provisions, recognising any discernible themes and patterns and underlying policy considerations.⁴⁶ This approach places a greater emphasis on the specific provision than the GAAR. If the specific provision covers the area in which the allegation of tax avoidance is said to relate, then there will be no room for the GAAR to apply.⁴⁷

⁴⁰ *Challenge Corporation* (PC), above n 6, at 561, per Lord Templeman. See generally Mike Lennard "Orthopod's Arrangements - Orthodoxy or Avoidance?" (2010) 41 *Taxation Today* 42, who provides further examples of statutory glosses which have been employed by the courts over the years.

⁴¹ *Ben Nevis*, above n 2, at [104].

⁴² See Cassidy, above n 13, at 30; Trombitas "The Conceptual Approach to Tax Avoidance in the 21st Century", above n 5, at 362-363. Contrast Ebersohn, above n 10, at 264.

⁴³ *Challenge Corporation* (CA), above n 6, at 544-545, 554-555.

⁴⁴ At 548-550.

⁴⁵ At 549.

⁴⁶ At 549.

⁴⁷ At 554-555.

On the facts of this case, the majority of the Court of Appeal held that the existence of a specific anti-avoidance provision relating to grouping of tax losses (which did not apply on these facts), excluded the GAAR from having any application.⁴⁸ On appeal, Lord Templeman delivering the judgment of the majority of the Privy Council, rejected this proposition but accepted the wider “scheme and purpose” approach.⁴⁹ Lord Templeman focused more on the underlying economic reality of the arrangement in holding that there was a tax avoidance arrangement.⁵⁰ Subsequent decisions in higher courts have upheld and applied Richardson J’s approach.⁵¹

5. The “parliamentary contemplation” test

The majority decision of the Supreme Court in *Ben Nevis* was aimed at settling the approach which should be applied to tax avoidance in New Zealand.⁵² The majority considered that the GAAR and specific provisions are meant to work together, and that “neither should be regarded as overriding.”⁵³ They stated that Parliament must have contemplated that the way in which a specific provision is utilised, would in some circumstances, be a tax avoidance arrangement under the GAAR.⁵⁴

A two-stage inquiry is involved to determine whether a specific provision can be utilised to generate a tax advantage. The first inquiry involves considering whether the specific provision is employed in a way which is inside its intended scope.⁵⁵ If the use of that provision is outside its intended scope, then a taxpayer will not be permitted by that provision to gain a tax advantage and will be in breach of the Act. If the first inquiry is answered affirmatively, the second step involves considering whether the specific provision “when

⁴⁸ At 542-544, 554-555.

⁴⁹ At 558-560.

⁵⁰ At 561-563.

⁵¹ See *Peterson v Commissioner of Inland Revenue* [2005] UKPC 5 at [36]-[40], [61]; *Commissioner of Inland Revenue v Auckland Harbour Board* (1999) 19 NZTC 15,433 (CA). See generally *Ben Nevis*, above n 2, at [96].

⁵² *Ben Nevis* above n 2, at [100]. This was the first opportunity that the Supreme Court had to address the issue of tax avoidance. The minority decision concurred with the result reached by the majority, but differed in their reasoning. They applied the English approach of a purposive interpretation of the specific provision (at the first stage of the majority’s two-step test) in order to avoid overuse of the GAAR in tax avoidance cases (at [2], per Elias CJ and Anderson J). The majority disagreed with this as they stated that a purposive interpretation of tax legislation is of little assistance in a New Zealand context because the English approach involves considerations which differ from the wording of our GAAR, as the English tax legislation has never had a GAAR(at [110]).

⁵³ At [103].

⁵⁴ At [104].

⁵⁵ At [107].

viewed in light of the arrangement as a whole”,⁵⁶ is utilised “in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision.”⁵⁷ If the arrangement is outside Parliament’s contemplation when viewed in a “commercially and economically realistic way”, then it will be a tax avoidance arrangement.⁵⁸

The Supreme Court stated that taxpayers are permitted to gain a tax advantage in two ways. The first is when they have utilised a specific provision in a manner which is within Parliament’s contemplation. The second is when the tax avoidance purpose or effect of the arrangement is “merely incidental”.⁵⁹ The phrase “merely incidental” is taken from the definition of “tax avoidance arrangement” in the GAAR.⁶⁰ It reflects the fact that many transactions will generate a tax saving, but it is only when the tax advantage is pursued as an end in itself that tax is a more than “merely incidental” purpose behind the arrangement.⁶¹ Although these are separate tests, in nearly all circumstances, the utilisation of a specific provision in a manner which is outside Parliament’s contemplation will result in the tax avoidance purpose or effect being not “merely incidental”.⁶² As these tests involve a consideration of similar factors, including whether an arrangement is artificial and contrived,⁶³ this dissertation will proceed on the basis that these two tests are interchangeable and that analysis of the “parliamentary contemplation” test can apply to the “merely incidental” test.⁶⁴ However, the statutory test must be satisfied before an arrangement can have a purpose of tax avoidance.⁶⁵

⁵⁶ At [107].

⁵⁷ At [107], [109].

⁵⁸ At [109].

⁵⁹ At [114].

⁶⁰ Income Tax Act 2007, s YA 1.

⁶¹ *Challenge Corporation (CA)*, above n 6, at 534, per Woodhouse P.

⁶² See *Ben Nevis*, above n 2, at [112]; *Russell v Commissioner of Inland Revenue* [2012] NZCA 128; (2012) 25 NZTC 20,120 at [42]; Nadine Armstrong "Scheme and Purpose, the Longstop, and Other Selected Tax Avoidance Themes in Light of the Westpac Decision" (2011) 17 NZJTL 443 at 468.

⁶³ *Russell* at [42]; Inland Revenue *Exposure Draft: Interpretation Statement INS0121 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, 16 December 2011 at [406]-[408].

⁶⁴ The Supreme Court’s approach to these two tests has been criticised by one commentator on the basis that it relegates the “merely incidental” test to being a statutory appendix to the main “parliamentary contemplation” test. See Craig Eliffe and Mark Keating "Tax Avoidance - Still Waiting for Godot?" (2009) 23 NZULR 368 at 391. While a focus on the statutory test would have greater legitimacy, a strictly literal application of the statutory test would lead to absurd results, because any tax advantage obtained could potentially fit under this wording. There is a need for an alternative approach which can be used to explain when taxpayers will be allowed to utilise specific statutory provisions to gain a tax advantage.

⁶⁵ See Inland Revenue *Interpretation Statement on Tax Avoidance*, above n 63, at [408]. The “merely incidental” test is likely to have greater application in a case where commercial purposes are alleged. This is because in this type of case, the commercial purpose or effect of the transaction has to be weighed against the purpose of gaining a tax advantage, to determine whether tax is a more than merely incidental motivator behind the

The Supreme Court made it clear that it is not confined to purely legal considerations,⁶⁶ and can look at a combination of relevant factors to decide whether an arrangement is outside Parliament's contemplation.⁶⁷ These factors include:⁶⁸

- The manner in which the arrangement is carried out.
- The role of the parties and their relationship with the taxpayer.
- Economic and commercial effect of documents.
- Commercial and economic reality.
- Duration of the arrangement.
- Nature and extent of the financial consequences.
- Whether the taxpayer gains the benefit of the specific provision in an artificial or contrived manner.

Ben Nevis provides an example of how the “parliamentary contemplation” test operates. In this case, the taxpayers claimed a deduction under a specific statutory provision⁶⁹ for an insurance premium paid as part of their investment in a forestry business.⁷⁰ The specific provision was utilised within its scope.⁷¹ However under the second step, there were several wider considerations which indicated that the arrangement was artificial and contrived as it did not have a commercial basis and was designed solely to obtain tax advantages. There was a 50 year timing difference between when the insurance premium was incurred for tax purposes, and when it would be paid in an economic sense.⁷² The insurance contract was not arms-length because the premiums were not fixed on any independent basis and paid to a company controlled by the promoter of the scheme.⁷³ These factors rendered the application of this statutory provision outside Parliament's contemplation. The use of these wider considerations raises questions as to how much this new test differs from the “scheme and purpose” test outlined by Richardson J.

arrangement. See *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834 at [205]-[212].

⁶⁶ *Ben Nevis* above n 2, at [109].

⁶⁷ At [108].

⁶⁸ At [108]-[109].

⁶⁹ Income Tax Act 1994, s DL 1(3) (now Income Tax Act 2007, s DP 1(1)).

⁷⁰ At [55]. The deductions claimed from the insurance premiums were only one part of the arrangement employed by the taxpayers in this case. The taxpayers also claimed a deduction for the depreciation of a license premium which related to the right to use the land on which the forest was planted (at [40]-[42]).

⁷¹ At [55]-[68].

⁷² This is because the insurance premium was paid using a promissory note, which the taxpayers were contractually liable to pay in 2047 (At [147]).

⁷³ At [148].

6. How does the “parliamentary contemplation” test differ from the “scheme and purpose” approach?

There has been debate by some commentators about the extent to which the “parliamentary contemplation” test represents a departure from the “scheme and purpose” approach. The difference between the two methods is relevant for both taxpayers and Inland Revenue, because it represents the approach which will be applied in a tax avoidance dispute. The extent that this approach has changed also provides a reference point to help determine whether our tax avoidance methodology has improved.⁷⁴

Trombitas is of the view that the “parliamentary contemplation” test does not represent a new approach, as ascertaining the intention of Parliament simply requires application of ordinary principles of interpretation.⁷⁵ Furthermore, if the Supreme Court wanted to make it clear that the approach had changed, it could have stated this explicitly in its judgment.

However, if the Supreme Court wished to affirm the “scheme and purpose” approach, it could have done so.⁷⁶ Several commentators and jurists have contended that there has been a major change in the approach to tax avoidance. Randerson J, who delivered the leading judgment of the majority of the Court of Appeal in *Penny and Hooper*, stated that decision in *Ben Nevis* effectively rejected the “scheme and purpose” approach which “reconciled conflicting provisions by reading down the scope of the general anti-avoidance provision.”⁷⁷ Two recent High Court decisions⁷⁸ and several commentators⁷⁹ are of a similar view.

The Supreme Court recognised that the “scheme and purpose” approach did not always require a strict focus on the specific provision, without considering wider factors.⁸⁰ The decision of Lord Templeman in the Privy Council demonstrates this.⁸¹ However Richardson J’s judgment outlining the “scheme and purpose” test has been the main form of guidance

⁷⁴ See discussion in Chapter Two, Section 4(e) – Alternatives to the “Parliamentary Contemplation” test.

⁷⁵ Trombitas “The Conceptual Approach to Tax Avoidance in the 21st Century”, above n 5, at 365.

⁷⁶ See Eliffe and Cameron, above n 5, at 450.

⁷⁷ *Commissioner of Inland Revenue v Penny and Hooper* [2010] NZCA 231, [2010] 2 NZLR 360 at [62]. This point was not addressed explicitly by the Supreme Court in *Penny and Hooper*, who merely affirmed the “parliamentary contemplation” test (see *Penny and Hooper* (SC), above n 3, at [33]).

⁷⁸ *BNZ Investments Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,582 (HC) (2009) at [116], per Wild J; *Westpac Banking Corporation v Commissioner of Inland Revenue* at [176], per Harrison J.

⁷⁹ See Cassidy, above n 13, at 21-23; Eliffe and Cameron, above n 5, at 350-352; David Dunbar “Tax Avoidance: The Court of Appeal Judgment in Penny and Hooper, the Application of the Parliamentary Contemplation Test, and the Demise of Scheme and Purpose” (2011) 17 NZJTLP 395 at 399, 405-406.

⁸⁰ *Ben Nevis*, above n 2 at [99].

⁸¹ See *Challenge Corporation* (PC), above n 6, at 562.

applied by subsequent courts.⁸² Given this fact, and because there was continuing uncertainty surrounding the relationship of the GAAR with specific provisions,⁸³ it was important for the Supreme Court to distance itself from Richardson J's approach. The Court has done this by rejecting an approach which reads down the scope of the GAAR by stating that it does not apply to arrangements which comply with a specific statutory provision.⁸⁴ In addition, by giving the GAAR and specific provisions equal weighting,⁸⁵ the Supreme Court has clearly indicated that the "parliamentary contemplation" test represents a change from the "scheme and purpose" test, to the extent it focused primarily on legalistic considerations.⁸⁶

The deliberate use of new terminology ("parliamentary contemplation") represents a change in the underlying approach taken to tax avoidance.⁸⁷ The "purpose" of an enactment is the mischief which it is designed to deal with, whereas the "contemplation" or intent of an enactment is the meaning of the enactment in its application to particular fact situations.⁸⁸ The Supreme Court's judgment uses both words when outlining its approach.⁸⁹ It uses the word "purpose" in relation to the specific statutory provision. One must then discover what Parliament has contemplated by considering what Parliament might allow or foresee in a particular fact situation with reference to the purpose of that provision. The inclusion of the word "contemplation" is used to indicate the fact-specific nature of the enquiry and the need to look at wider considerations, such as the commercial and economic reality of the arrangement,⁹⁰ rather than only looking at Parliament's purpose which is reflected in the text of the statute.⁹¹ A broader approach is now taken on the issue of tax avoidance, and indicates

⁸² For example, a later Privy Council decision placed greater emphasis on Richardson J's approach. See *Peterson*, above n 51 at [61].

⁸³ *Ben Nevis* at [100].

⁸⁴ At [89]. Contrast Armstrong, above n 62, at 454-456, who disagrees with the way that the Supreme Court has construed Richardson J's application of the "scheme and purpose" approach.

⁸⁵ At [107].

⁸⁶ Any subsequent references to the "scheme and purpose" approach in this dissertation should be understood as referring to Richardson J's formulation of this approach.

⁸⁷ Eliffe and Cameron, above n 5 at 450.

⁸⁸ See Francis Bennion *Bennion on Statutory Interpretation* (5th ed, LexisNexis, London, 2008) at 483-484, 943.

⁸⁹ *Ben Nevis* at [107]-[109]. This would also explain why in *Penny and Hooper* (SC) above n 3, the Supreme Court only referred to "parliamentary contemplation" and not Parliament's purpose. Rather than indicating a different test to be applied in tax avoidance cases by omitting reference to Parliament's purpose, the better view is that in this case, because there was no specific statutory provision which the taxpayers utilised in order to gain a tax advantage, there was no need to refer to Parliament's purpose. The Supreme Court was limited to examining "parliamentary contemplation" in that case as it only had wider considerations to consider in order to determine whether there was a tax avoidance arrangement. See also Chapter Three, Section 1(d) - How does the decision in *Penny and Hooper* align with the approach taken by the Supreme Court in *Ben Nevis*?

⁹⁰ *Ben Nevis* at [107]-[109].

⁹¹ *Bennion on Statutory Interpretation* at 469-471.

that the GAAR may catch some transactions which would have previously escaped its reach.⁹²

Given this conclusion, it is important to understand the scope of this approach and how it will be applied in practice. The following chapter will critically analyse the “parliamentary contemplation” test and the key issue of certainty. In particular, this chapter will address whether a justifiable level of certainty is provided to allow taxpayers to have sufficient guidance on which to structure their affairs, whilst ensuring that the GAAR retains sufficient flexibility to effectively counter tax avoidance. Chapter Three will continue this theme by focusing on the application of the “parliamentary contemplation” test to the use of company/trust structures in *Penny and Hooper*,⁹³ in order to provide a practical analysis of the discussion about certainty in that context.

⁹² Littlewood “Tax Avoidance, the Rule of Law, and the New Zealand Supreme Court”, above n 25, at 53-54.

⁹³ Above n 3.

CHAPTER TWO: CRITICAL ANALYSIS OF THE “PARLIAMENTARY CONTEMPLATION” TEST – DOES THIS TEST PROVIDE A JUSTIFIABLE LEVEL OF CERTAINTY IN THIS AREA OF LAW?

1. The key issue - certainty

A lot of the debate around the “parliamentary contemplation” test centres on the issue of certainty, or lack of it, in this area of law. At the centre of this debate is a clash of two conflicting values. One is the need for taxpayers to be able to know in advance how their business arrangements will be treated under the law.⁹⁴ On the other hand, there is a need for each taxpayer to pay their fair share of taxes.⁹⁵ To achieve this goal, the GAAR needs to be effective in countering tax avoidance. By making the standard for tax avoidance somewhat vague, the flexibility of the courts to deal with instances of tax avoidance is enhanced. By operating in this manner, the GAAR also provides a deterrent effect against overzealous tax planning by creating doubt over the legal treatment of aggressive tax arrangements.⁹⁶

This chapter will outline why certainty is desirable in this area of law, and will explain how the “parliamentary contemplation” test has left the law in an uncertain state. This will be followed by a consideration of factors which mitigate concerns about uncertainty, a comparison of tax avoidance with other areas of law where vague standards are applied, and will address why tax avoidance is an inherently uncertain area of law. This chapter will conclude by explaining why the level of certainty in the “parliamentary contemplation” test is justifiable, since certainty cannot be a desirable or achievable aim for the law in this area.

2. Why is certainty valued in this area of law?

Certainty is a desirable aspect in any tax system. Taxpayers need to be able to distinguish between a permissible tax advantage and the tax advantages Parliament did not intend to permit.⁹⁷ Sir Ivor Richardson writing extra-judicially, states that the problem with the GAAR operating in an uncertain manner is that it hinders the effective functioning of the tax system

⁹⁴ G. T. Pagone "General Anti Tax Avoidance Provisions in Australia and New Zealand" (paper presented to New Zealand Trust Conference, Auckland, 30 March 2012) at 34.

⁹⁵ Trombitas “The Conceptual Approach to Tax Avoidance in the 21st Century”, above n 5, at 388.

⁹⁶ Keating and Keating, above n 26 at 137; Trombitas “The Conceptual Approach to Tax Avoidance in the 21st Century” at 354.

⁹⁷ See *Peterson*, above n 51, at [60], *Ben Nevis*, above n 2, at [106].

and “may inhibit some desirable activity, damage relations between Inland Revenue and the general body of taxpayers and tie up scarce resources while the parties skirmish”.⁹⁸

One of the key aspects of an effective tax system is that compliance costs should be kept as low as possible.⁹⁹ If the law on tax avoidance is too unsettled, this will increase administrative costs faced by taxpayers in complying with the law and Inland Revenue in administering the law.¹⁰⁰ A further consequence of engaging in tax avoidance is being subject to a potential additional penalty of up to 100% of the amount in dispute.¹⁰¹ Furthermore, tax avoidance disputes with Inland Revenue are a lengthy process, where issues often take three to six years before the taxpayer has a hearing in court.¹⁰² Because of the consequences of getting it wrong, taxpayers may have to spend extra sums of money on determining the scope of their obligations to minimise their risk of incurring an extra tax liability.¹⁰³ These transaction costs represent a cost to the economy as a whole.¹⁰⁴

Furthermore, the application of the GAAR in a vague manner is contrary to the requirement of the rule of law that the Executive’s discretion in applying the law should be restricted.¹⁰⁵ There is a risk that if tax avoidance law is too uncertain, Inland Revenue would have too much leeway in deciding whether to invoke the GAAR. This is undesirable, as it is a fundamental constitutional principle that taxation must be levied by Parliament, not the Executive.¹⁰⁶ In addition, an indeterminate application of the GAAR breaches the rule of law requirement that the law should be certain.¹⁰⁷

⁹⁸ Ivor LM Richardson "Countering Tax Avoidance" (2004) 10 NZJTL 301 at 304.

⁹⁹ Victoria University of Wellington Tax Working Group *A Tax System for New Zealand's Future* (January 2010) at 15.

¹⁰⁰ Keating and Keating, above n 26, at 138.

¹⁰¹ See Tax Administration Act 1994, s 141D.

¹⁰² *Improving the Operation of New Zealand's Tax Avoidance Laws*, above n 5, at 10.

¹⁰³ At 5.

¹⁰⁴ *A Tax System for New Zealand's Future*, above n 99, at 13.

¹⁰⁵ Joseph Raz "The Rule of Law and its Virtue" (1977) 93 LQR 195 at 199-202.

¹⁰⁶ Bill of Rights 1688. This enactment remains law in New Zealand under Section 2 of the Imperial Laws Application Act 1988.

¹⁰⁷ Rebecca Prebble and John Prebble "Does the use of general anti-avoidance rules to combat tax avoidance breach principles of the rule of law? A comparative study" (2010) 55 St Louis ULJ 21 at 28.

3. Uncertainty in the “parliamentary contemplation” test

(a) What is within Parliament’s contemplation?

The majority judgment in *Ben Nevis* was comfortable with the level of certainty provided by the “parliamentary contemplation” test and stated that most cases can be decided without too much difficulty, with only difficult cases at the margins.¹⁰⁸ Some commentators disagree with this sentiment and contend that this test leaves taxpayers facing an uncertain outcome.¹⁰⁹

Most commercially-minded people are motivated by tax considerations when structuring their arrangements and tax is viewed as another cost of doing business. These taxpayers need some sort of principled basis which they can use to determine whether a particular arrangement is within Parliament’s contemplation. This task can be difficult in nature. For example, how is the utilisation of the PIE rules¹¹⁰ to gain a tax advantage within Parliament’s contemplation, but other arrangements such as the one in *Penny and Hooper*, are not?¹¹¹ The arrangement in *Penny and Hooper* involved two taxpayers who transferred their separate orthopaedic practices to a company. In both instances, the family trust was the majority shareholder of this company, and each taxpayer and their family were beneficiaries of this trust. They paid low salaries to themselves as employees and the trust received the rest of the income as dividends. They gained a tax advantage because most income derived by the company incurred tax at the trustee rate rather than the top marginal income tax rate (which applied to the salaries). Despite being described by the Supreme Court as an “entirely lawful and unremarkable” structure,¹¹² the Court found that these structures were outside Parliament’s contemplation and constituted a tax avoidance arrangement.¹¹³

The Supreme Court has provided a list of factors which indicate whether an arrangement is inside Parliament’s contemplation.¹¹⁴ These factors are largely conclusory and descriptive in nature, rather than being useful in predicting whether tax avoidance exists.¹¹⁵ Pagone states that there is a danger in these indicators being applied as tautologies to the facts of other

¹⁰⁸ *Ben Nevis* above n 2, at [112].

¹⁰⁹ Eliffe and Cameron, above n 5, at 458-459; Trombitas “The Conceptual Approach to Tax Avoidance in the 21st Century”, above n 5, at 365-366, 377, 387; Keating, above n 5, at 2-4; *Improving the Operation of New Zealand’s Tax Avoidance Laws*, above n 5, at 9-10.

¹¹⁰ See subpart HM of the Income Tax Act 2007.

¹¹¹ See *Penny and Hooper* (SC), above n 3, at [49]. This question is revisited in Chapter Two, Section 6 – Comparison to other areas of law.

¹¹² At [33].

¹¹³ At [49]. The issues in this case are discussed in more detail in Chapter Three.

¹¹⁴ *Ben Nevis*, above n 2, at [108]-[109].

¹¹⁵ Michael Lennard “Two Tribes and an Elephant Called Ben Nevis” (2009) 33 Taxation Today at 8.

cases.¹¹⁶ It is easy to describe a tax avoidance arrangement as artificial and contrived with the benefit of hindsight, but it is more difficult to predict whether a court will describe a particular arrangement in this manner.

Uncertainty in the current approach to tax avoidance is evident in the recently released Inland Revenue Draft Interpretation Statement on Tax Avoidance.¹¹⁷ The interpretation statement states that in some cases determining Parliament's contemplation will require a focus on the commercial reality and economic effects of the arrangement, whilst in other cases a greater focus on the legislation is required.¹¹⁸ As the Income Tax Act often fails to give a clear indication of Parliament's intent, and because commercial and economic reality is an equivocal concept, it is likely that there will continue to be many instances where taxpayers and Inland Revenue differ on the issue of tax avoidance.

This leaves open the possibility of a taxpayer arguing that an arrangement is within Parliament's contemplation on the basis that the particular tax treatment is within the purpose of the specific provision,¹¹⁹ whilst Inland Revenue may take an opposing stance, relying on a broader fiscal policy based on the commercial and economic effects of the arrangement.¹²⁰ The question remains as to when the purpose of the specific provision is a sufficiently strong indicator of Parliament's intent to override other factors? The interpretation statement concludes that to identify Parliament's purpose, one must determine if Parliament had foreseen transactions of that particular type when enacting the legislation, would that transaction have been within its purpose.¹²¹ This circular reasoning is not particularly helpful. As only general factors have been given to indicate when an arrangement is within Parliament's contemplation (despite Inland Revenue producing over 100 pages on the subject), there is considerable scope for uncertainty.

¹¹⁶ Pagone, above n 94, at 32.

¹¹⁷ Inland Revenue *Tax Avoidance and the Interpretation of Sections BG 1 and GA 1 of the Income Tax Act 2007*, above n 63. This interpretation statement is based on recent case law, and was released in light of the Supreme Court's decisions in *Ben Nevis* and *Penny and Hooper*.

¹¹⁸ At [334]-[337], [524].

¹¹⁹ Legal considerations are still relevant under the "parliamentary contemplation" test. See *Ben Nevis*, above n 2, at [109].

¹²⁰ Pagone, above n 94, at 33.

¹²¹ Inland Revenue *Tax Avoidance and the Interpretation of Sections BG 1 and GA 1 of the Income Tax Act 2007*, above n 63, at [358].

(b) When is “parliamentary contemplation” assessed?

There is a difficulty in determining the point of view from which Parliament’s contemplation is assessed. Is it assessed from the viewpoint of the Parliament who enacted the legislation or some hypothetical Parliament?¹²² For example, in *Penny and Hooper*, the Parliament at the time the top marginal income tax rate was raised, did discuss the possibility of the tax avoidance opportunity which arose in that case,¹²³ and enacted a specific anti-avoidance provision (the PSA rules)¹²⁴ to counter the use of company/trust structures,¹²⁵ but this provision did not apply on the facts of that case. Therefore it could be argued that Parliament did contemplate the fairly predictable form of tax avoidance which arose, but decided not to legislate against it.¹²⁶ In response, one could argue that Parliament only intended the PSA rules to apply to the specific situation contemplated by those rules, whilst allowing the GAAR to apply in other situations.¹²⁷

The Supreme Court’s focus on factors such as salary levels, in contrast to the limited emphasis placed on parliamentary materials¹²⁸ indicates that the focus is on what a hypothetical Parliament might contemplate. This has been confirmed in recent High Court and Court of Appeal decisions.¹²⁹ Looking at what a hypothetical Parliament’s contemplation is more logical, as it would be impractical to expect the Parliament which enacts a piece of legislation to contemplate every ingenious scheme which taxpayers utilise at the time it enacted the legislation.

The invocation of a hypothetical Parliament to determine a tax avoidance dispute is a legal fiction. In reality, it is the court who is deciding whether Parliament would contemplate such a scheme. Such a hypothetical Parliament only exists within the mind of the court. This concept differs from an ordinary purposive interpretation of legislation where a court

¹²² See Dunbar, above n 79, at 407.

¹²³ (22 December 1999) 581 NZPD 152, as cited in *Improving the Operation of New Zealand’s Tax Avoidance Laws*, above n 5, at 21.

¹²⁴ Income Tax Act 2007, ss GB 27 – GB 29.

¹²⁵ See Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill (27-2) (select committee report), as cited in *Penny and Hooper* (SC), above n 3, at [48].

¹²⁶ See *Penny and Hooper* (CA), above n 77, at [168] where Ellen France J described the structure employed by the taxpayers as not requiring any particular ingenuity.

¹²⁷ See *Penny and Hooper* (SC) at [48]; Patricia Leong "Penny and Hooper" [2011] NZLJ 339 at 344.

¹²⁸ The Select Committee Report on the Bill which implemented the increase in the tax rate and the PSA rules was cited in support of the decision the Court made. However this was not the primary reason for the decision. See *Penny and Hooper* (SC), above n 3, at [48].

¹²⁹ *BNZ Investments v Commissioner of Inland Revenue*, above n 78, at [135]; *Russell v Commissioner of Inland Revenue*, above n 63, at [39]. See also *Inland Revenue Tax Avoidance and the Interpretation of Sections BG 1 and GA 1 of the Income Tax Act 2007*, above n 63, at [358].

determines Parliament's intention, primarily by reference to the Statute itself.¹³⁰ By invoking this façade of a hypothetical Parliament, the courts are not strictly confined to the legal text or Parliament's purpose as reflected in the Act, when making a decision.

This concept appears to mask a new role for the courts to make decisions in this area.¹³¹ This raises concerns that the courts are over-stepping their role and becoming de-facto legislators by employing the GAAR to give legal effect to something which Parliament has failed to enact but presumed to have contemplated.¹³² Especially in a situation dealing with a complex or unusual transaction, a lack of clarity in the "parliamentary contemplation" test may allow Parliament's contemplation to be interpreted in a way in which a Judge would think best,¹³³ with a sense of morality infiltrating decision-making. This will be hard to determine, because a Judge is unlikely to make impressionistic reasoning explicit in their judgment.¹³⁴ This is nothing new, as tax avoidance is one area of law where tax policy and judicial activism frequently influence decision-making.¹³⁵ This is not to condone such reasoning, but merely noting that it will be present in whatever approach we take to the issue of tax avoidance. However, this does suggest the potential for increased uncertainty if judges invoke the "parliamentary contemplation" test to make a decision based on their assessment of the subjective merits of the case.

4. Mitigation of concerns about certainty

(a) Binding ruling

One method of avoiding uncertainty when a taxpayer is unsure whether their arrangement falls under the GAAR is to get a binding ruling from Inland Revenue.¹³⁶ This may be a sensible step for taxpayers who could otherwise face a large tax burden if they get their tax position incorrect.

¹³⁰ *Bennion on Statutory Interpretation*, above n 88, at 469-472.

¹³¹ Dunbar, above n 79, at 407.

¹³² At 406; Eliffe and Cameron, above n 5, at 459; Pagone, above n 94, at 34.

¹³³ Dunbar at 407-408; Trombitas "The Conceptual Approach to Tax Avoidance in the 21st Century", above n 5, at 356.

¹³⁴ Especially since the Supreme Court has warned against doing this. See *Ben Nevis*, above n 2, at [102].

¹³⁵ Keating and Keating, above n 26, at 115.

¹³⁶ See *Glenharrow Holdings Limited v Commissioner of Inland Revenue (2009) 24 NZTC 23* at [49]. A binding ruling can be sought under s 91C Tax Administration Act 1994, and is binding on the Commissioner of Inland Revenue under sections 91DB and 91EA Tax Administration Act 1994.

This will not be an appropriate solution in all situations. The large cost of getting a ruling (which can exceed \$50,000),¹³⁷ will exclude some taxpayers. In many instances, the relatively small amount of tax in dispute will not justify the expense involved. The current timeframe for getting a binding ruling (three to five months),¹³⁸ will discourage taxpayers who cannot afford to wait this long. In addition, a favourable binding ruling does not eliminate the risk of a future dispute with Inland Revenue as it is subject to assumptions and conditions, which Inland Revenue could audit at a later stage.¹³⁹ Getting a binding ruling is no “silver bullet” fix to the issue of certainty, as it is only useful in some cases.¹⁴⁰

(b) Penalties

The possibility of penalties being applied in a case of tax avoidance is lessened by the fact that a more stringent standard has to be met before penalties can be imposed. To apply penalties to a tax avoidance arrangement, it must be shown that the taxpayer has adopted an “abusive tax position”.¹⁴¹ To prove an “abusive tax position”, it must be shown that the taxpayer has entered into an arrangement with the “dominant purpose of avoiding tax”.¹⁴² By contrast, the GAAR requires “tax avoidance” to be one or more of the purposes or effects of the arrangement, provided that this purpose or effect is not “merely incidental”.¹⁴³ Penalties are only likely to be applied in more egregious cases of tax avoidance which have a dominant purpose of tax avoidance.¹⁴⁴ There can be less concern about penalties applying in these cases.

Even if the “parliamentary contemplation” test contains some uncertainty in relation to borderline cases of tax avoidance, the only consequence is that the taxpayer pays the amount

¹³⁷ Refer to *Improving the Operation of New Zealand’s Tax Avoidance Laws*, above n 5, at 11.

¹³⁸ At 11.

¹³⁹ At 11.

¹⁴⁰ Some of these problems could be fixed if the IRD applied more resources to providing binding rulings.

¹⁴¹ Tax Administration Act 1994, s 141D.

¹⁴² Tax Administration Act 1994, s 141D (7)(b)(ii). Note that there is an additional requirement to prove an “abusive tax position”. It must also be proved that the taxpayer has taken a position which involves an “unacceptable interpretation of a tax law” (ss 141D(4) and (7)(a)), defined as failing to “meet the standard of being .. about as likely as not to be correct” when viewed objectively (s 141B(1)(b)). In addition, a penalty will only be imposed, if that the tax shortfall arising from the taxpayers’ tax position exceeds \$10,000 (s 141D(4)).

¹⁴³ Income Tax Act 2007, ss BG 1, YA 1 (definition of “tax avoidance arrangement”).

¹⁴⁴ There are some doubts about whether the two standards are different. Shelley Griffiths is of the view that the wording of s 141D is too dense and ambiguous to make it clear which instances of tax avoidance the penalty will apply to (see Shelley Griffiths “The ‘Abusive Tax Position’ in the Tax Administration Act 1994: An Unstable Standard for a ‘Penal’ Provision?” (2009) 15 NZJTL 159). This dissertation will not attempt to address this issue and will assume that the test for a “tax avoidance arrangement” under s BG 1 Income Tax Act 2007 is easier to prove than the test for an “abusive tax position” under s 141D Tax Administration Act, based on the differences in the statutory wording.

of tax they should have paid in the first place. Penalties are unlikely to apply in borderline cases because these usually do not have a dominant purpose of tax avoidance. However, there is a reputational risk of being involved in tax avoidance.¹⁴⁵ In addition, the likelihood that some tax avoidance cases will involve large monetary sums, demands a degree of certainty in the application of the GAAR, even when penalties are not applied.

(c) Judicial discretion

Some judicial discretion is involved in determining parliamentary contemplation, as the enquiry is factual in nature.¹⁴⁶ Decisions based upon subjective impressions of the morality of an arrangement must be strongly discouraged.¹⁴⁷ The possibility of this occurring does not necessarily indicate that the judiciary is actually deciding cases on these grounds. The criticism that the notion of a hypothetical Parliament is a legal fiction is lessened by the realisation that income tax law is founded upon a series of legal fictions, such as the capital/revenue distinction.¹⁴⁸ Furthermore, it is unknown as yet whether the application of this test has actually resulted in increased compliance costs for taxpayers, given that tax avoidance has long been an uncertain area of law.¹⁴⁹

(d) Rule of law

Rule of law concerns are lessened due to the fact that it is the courts and not Inland Revenue who determine the application of the GAAR in a particular case.¹⁵⁰ Parliament, when enacting the GAAR, decided to leave it deliberately general, and has left it up to the courts to interpret the GAAR and decide which arrangements this provision should apply to in difficult cases.¹⁵¹ Even if the GAAR is contrary to the requirements of the rule of law on the basis that

¹⁴⁵ Keating and Keating, above n 26, at 133-134.

¹⁴⁶ See *Ben Nevis*, above n 2, at [102], [108]. Inland Revenue *Interpretation Statement on Tax Avoidance* at [24], [333], states that the exercise of determining Parliament's contemplation will depend on "the particular use of the Act made by the arrangement".

¹⁴⁷ *Ben Nevis* at [102].

¹⁴⁸ See John Prebble "Income Taxation: A Structure Built on Sand" (Sydney University Law School, Parsons Lecture, 14 June 2001).

¹⁴⁹ See Chapter Two, Section 5 – Tax avoidance is inherently uncertain.

¹⁵⁰ Prebble "Income Taxation: a Structure built on Sand" at 312.

¹⁵¹ *Ben Nevis*, at [101], [112].

the law is somewhat uncertain, this breach can be justified on the basis that it is necessary to ensure that the GAAR is effective in countering that tax avoidance.¹⁵²

(e) Alternatives to the “parliamentary contemplation” test

(i) “Scheme and purpose” test

While it is easy to criticise the “parliamentary contemplation” test, there has to be a viable alternative. A return to Richardson J’s “scheme and purpose” approach would not necessarily provide more certainty. Lennard states that under the “scheme and purpose” approach, two of the most respected legal minds on tax (Lord Templeman and Richardson J), came to different conclusions on whether the scheme employed in *Challenge Corporation*¹⁵³ amounted to a tax avoidance arrangement.¹⁵⁴ He also notes that in *Peterson*,¹⁵⁵ the Privy Council was split 3:2 when applying the same approach.¹⁵⁶ This demonstrates that the “scheme and purpose” approach did not provide a clear answer for all interpretation problems.¹⁵⁷

The “scheme and purpose” approach is difficult to apply in a situation where no specific statutory provisions are utilised to gain a tax advantage. An example of these difficulties is seen in *Penny and Hooper*. One could argue that the existence of the graduated rate scheme of the Income Tax Act is a legislative indicator which demonstrates that the taxpayers’ arrangement was contrary to the scheme and purpose of the legislation.¹⁵⁸ Alternatively, one could contend that this argument does not apply when income is no longer derived by an individual taxpayer, as the Act does not distinguish between business income and income derived by an individual taxpayer.¹⁵⁹ Furthermore, one could point to the existence of a specific anti-avoidance provision (the PSA rules) which did not apply to the taxpayers’

¹⁵² Prebble and Prebble, above n 107 at 43-45.

¹⁵³ Above n 6.

¹⁵⁴ Lennard “Two Tribes and an Elephant Called Ben Nevis”, above n 115, at 9-10.

¹⁵⁵ Above n 51.

¹⁵⁶ At 10.

¹⁵⁷ Richardson J (writing extra-judicially) stated that the “scheme and purpose” approach would not provide an answer to all interpretation problems in cases where the scheme of the legislation is not coherent and the underlying purpose is not readily discernible: See Ivor LM Richardson “Appellate Court Responsibilities and Tax Avoidance” (1985) 2 ATR 3 at 9.

¹⁵⁸ See *Penny and Hooper* (CA), above n 77, at [159]-[160], per Hammond J.

¹⁵⁹ After the re-structuring, the individual taxpayers were not deriving any income, but the company was deriving income instead. See *Penny v Commissioner of Inland Revenue* [2009] 3 NZLR 523 (HC), at [38]-[40], per McKenzie J.

arrangement, as demonstrating that the scheme and purpose of the Act did not prohibit that arrangement,¹⁶⁰ as the Court of Appeal did in *Challenge Corporation*.

How is one to distinguish between the different indicators provided in the legislation, and come to an overall conclusion? The specific provision will not provide any way of distinguishing between the various indicators in the legislation, so the GAAR is required to perform this role. The problem with reading down the operation of the GAAR under the “scheme and purpose” approach is that the scope of s BG 1 is determined without reference to the section itself.¹⁶¹

This raises questions as to the basis on which the courts are determining the scope of the GAAR, if they are not using the wording of the provision itself to determine this.¹⁶² The “parliamentary contemplation” test is preferable because it is derived from the GAAR’s definition of “tax avoidance arrangement”,¹⁶³ which requires a consideration of the purposes or effects of an arrangement.¹⁶⁴ This is demonstrated in the “parliamentary contemplation” test as it focuses on commercial and economic reality, and concepts such as artificiality and contrivance.¹⁶⁵ When an arrangement is viewed in light of commercial and economic reality, one can determine whether that arrangement has a true commercial purpose (which is enough to render tax avoidance as “merely incidental”), or is artificial and contrived, with tax avoidance being one of the purposes or effects behind the structuring of that arrangement.¹⁶⁶

This discussion highlights that the “scheme and purpose” approach did not necessarily bring any certainty in this area. The “parliamentary contemplation” test may not necessarily provide a greater or lesser level of certainty, but this value is of less importance in this area of law.¹⁶⁷ Furthermore, the “parliamentary contemplation” test represents an improvement because it gives equal emphasis to the GAAR and the specific statutory provision,¹⁶⁸ and is actually derived from the wording of the GAAR.

¹⁶⁰ *Penny and Hooper* (HC) at [41].

¹⁶¹ Ebersohn, above n 10, at 260-261.

¹⁶² At 260-261.

¹⁶³ See *Alesco New Zealand & Ors v Commissioner of Inland Revenue (No 2)* (2011) 25 NZTC 20,099 at [86]-[87], per Heath J; Ebersohn at 263-264.

¹⁶⁴ Income Tax Act 2007, s YA 1.

¹⁶⁵ *Ben Nevis*, above n 2, at [108]-[109].

¹⁶⁶ Ebersohn at 263-264.

¹⁶⁷ See Chapter Two, Section 7 – Tax avoidance law cannot prioritise certainty.

¹⁶⁸ Refer to *Ben Nevis*, above n 2, at [102].

(ii) Legislative amendment

Trombitas favours the view that in difficult cases where Parliament's intention is not clear, courts should be reluctant to apply the GAAR because of its indeterminate nature. On this standpoint, one can only assess Parliament's contemplation by reference to the language employed in the statute.¹⁶⁹ Any imperfect expressions of Parliament's intention should be remedied by Parliament through legislative amendment,¹⁷⁰ rather than the GAAR.

Taxpayers will continue to engage in "creative compliance" by manipulating the rules in order to gain a tax advantage.¹⁷¹ Relying primarily on Parliament's legislative powers will not be effective in combating tax avoidance, as it will only operate once an arrangement has been uncovered.¹⁷² Once Parliament has closed one loophole, a taxpayer may be able to find another one to exploit. As Littlewood notes, the legislature would be "forever shutting the door after the horses have bolted."¹⁷³

However, there is a danger of over-reliance upon the GAAR to fill gaps in the legislation.¹⁷⁴ For this reason, the legislative process is a preferable way of combating tax avoidance. This provides taxpayers with a greater degree of certainty by shutting some doors or limiting the method of entry. Parliament should be aware of the consequences of granting tax concessions or presenting choices to taxpayers in the Income Tax Act, as these can provide incentives for taxpayers to construe these provisions to their advantage.¹⁷⁵ Good tax policy design can limit opportunities for tax avoidance and the need to invoke the GAAR.¹⁷⁶

Nevertheless, Parliament cannot be expected to legislate to cover all possible instances of tax avoidance given the wide range of scenarios in which tax avoidance could eventuate.

¹⁶⁹ Lord Hoffman is of this view. See *MacNiven (Inspector of Taxes) v Westmoreland Investments Ltd* [2003] 1 AC 311 (HL); Lord Hoffman "Tax Avoidance" [2005] BTR 197.

¹⁷⁰ Trombitas "The Conceptual Approach to Tax Avoidance in the 21st Century", above n 5, at 388-389.

¹⁷¹ Freedman "Interpreting tax statutes", above n 22, at 346.

¹⁷² See Chapter One, Section 2 – The need for a GAAR.

¹⁷³ Littlewood, above n 25, at 39.

¹⁷⁴ Dunbar, above n 79, at 406; Pagone, above n 94, at 34. See also *Canada Trustco Mortgage Co v Canada* (2005) SCC 53 at [41].

¹⁷⁵ Trombitas, above n 5, at 355-356. For example in *Penny and Hooper (SC)*, above n 3, when the top marginal income tax rate was raised, this encouraged taxpayers to employ company/trust structures to avoid the impost of this higher tax rate. Another example is *Peterson*, above n 51, where statutory provisions which provided a tax incentive to invest in films encouraged taxpayers to utilise those provisions to gain a tax advantage, giving rise to a tax avoidance dispute.

¹⁷⁶ Richardson, above n 98, at 307, notes that while the GAAR is useful, it should not be the sole peg on which the system rests. He states that a good modern income tax system must also involve "specific anti-avoidance provisions, rate structures, and sound, workable and timely quantification and dispute resolution processes" which will reduce the incentives for avoidance, and thus reducing the need to invoke the GAAR.

Therefore, it should not be presumed that the GAAR does not apply in situations where Parliament has not closed a particular door unless it is clearly evident from the legislation.¹⁷⁷

5. Tax avoidance is inherently uncertain

Tax avoidance is a difficult issue to define and the courts have struggled over the years to outline principles and guidelines which sufficiently define its scope. No matter which approach is taken, tax avoidance has always been one of the more difficult areas of law. Uncertainty is inevitable whenever a taxing statute contains a GAAR.¹⁷⁸ However, the uncertainty surrounding tax avoidance may simply reflect the uncertainty of rules defining the scope of income tax,¹⁷⁹ as other countries such as the United Kingdom which do not have a GAAR still experience uncertainty in this area.¹⁸⁰ As Prebble states, tax law is often complex and difficult to understand.¹⁸¹

One key area of tax law is the capital/revenue distinction.¹⁸² Both income and capital represent a gain in an economic sense, yet income is taxable and capital is not. It is sometimes difficult to distinguish between income and capital, as these two concepts often merge into each other.¹⁸³ Capital items really represent the present value of future revenue streams. For example, the courts have held that a rent payment by a lessee is revenue in nature and therefore deductible, whereas a lease inducement payment¹⁸⁴ received by that lessee is capital in nature.¹⁸⁵ However, an inducement payment also has a revenue nature as it operates effectively like a rent subsidy by reducing the total amount of rent payable every month. If this inducement payment was not one-off, but received at regular intervals, a court

¹⁷⁷ *Penny and Hooper* (SC), above n 3, at [48], *Challenge Corporation* (PC), above n 6, at 559.

¹⁷⁸ *Glenharrow Holdings Limited v Commissioner of Inland Revenue*, above n 136, at [48].

¹⁷⁹ See Prebble "Income Taxation: a Structure Built on Sand", above n 148 at 312.

¹⁸⁰ Michael Littlewood "The Privy Council and the Australasian anti-avoidance rules" [2007] BTR 175 at 204; Littlewood "Tax Avoidance, the Rule of Law and the New Zealand Supreme Court", above n 25, at 66.

¹⁸¹ John Prebble "Why is tax law incomprehensible?" [1994] BTR 380 at 381-384.

¹⁸² Note that when referring to the capital/revenue distinction, the words revenue and income can be used interchangeably.

¹⁸³ Prebble "Why is tax law incomprehensible" at 386-387.

¹⁸⁴ A lease inducement payment is a lump sum designed to encourage a commercial tenant to enter into a long-term lease

¹⁸⁵ See *Wattie v CIR* (1997) 18 NZTC 13,297 (CA); *CIR v Wattie* [1999] 1 NZLR 529 (PC). The Minister of Revenue has announced that a Bill will be introduced into Parliament that will reverse the effect of this decision by treating lease inducement payments as taxable. See Hon Peter Dunne, Minister of Revenue "Dunne: lease inducement changes reflect feedback" (media statement, 27 September 2012).

would be more willing to hold that it is revenue in nature. But how regular would these intervals need to be, before this item is classified as revenue in nature?

The nebulous distinction between capital and income demonstrates that uncertainty is present, even at the very core concept of income, the foundation which taxation law is based upon. This distinction also encourages taxpayers to try to find ways of converting income items in non-taxable capital gains, in order to pay less tax, generating more cases where tax avoidance is an issue.¹⁸⁶ Therefore, it is arguable that the uncertainty in the concept of tax avoidance simply reflects the imprecise nature of the concept of income,¹⁸⁷ rather than the particular approach taken to tax avoidance in this area. This problem is exacerbated by taxpayers' willingness to push the boundaries of the capital/revenue distinction.

Due to the imprecise nature of tax law and tax avoidance itself, it can only be dealt with in a concept format and it is impossible to provide a definitive list of which arrangements constitute tax avoidance. This is why it is acceptable for the "parliamentary contemplation" test to only give general indicators about what constitutes tax avoidance.¹⁸⁸ Incorporating these indicators in statute would not necessarily provide more clarity in this area. Some have argued that the GAAR should be amended to contain indicators of tax avoidance,¹⁸⁹ such as the Australian GAAR,¹⁹⁰ which contains similar indicators to what the Supreme Court stated in *Ben Nevis*.¹⁹¹ This may add unnecessary layers of complexity to an enquiry by requiring a focus on some factors which are irrelevant to a decision. Such a provision will not generate more certainty as it would not state how much weighting should be given to the different factors, and does not add anything to the test stated by the Supreme Court in *Ben Nevis*.¹⁹²

¹⁸⁶ Prebble "Why is tax law incomprehensible" at 391.

¹⁸⁷ Prebble "Income Taxation: a Structure Built on Sand", above n 148, at 312-313.

¹⁸⁸ Ebersohn, above n 10, at 269.

¹⁸⁹ Cassidy, above n 13, at 32-33; Trombitas "The Conceptual Approach to Tax Avoidance in the 21st Century", above n 5, at 389. Contrast Ebersohn, above n 10, at 271-272; Littlewood "Tax Avoidance, the Rule of Law and the New Zealand Supreme Court", above n 25, at 66-68.

¹⁹⁰ Income Tax Assessment Act 1997 (Cth), s 177D.

¹⁹¹ See *Ben Nevis*, above n 2, at [108]-[109].

¹⁹² Littlewood "Tax Avoidance, the Rule of Law and the New Zealand Supreme Court", above n 25, at 66-68. The only benefit that legislative amendment could provide is that it will add greater legitimacy to the "parliamentary contemplation" test.

6. Comparison to other areas of law

Uncertainty is not necessarily the reason for the large number of tax avoidance cases hitting the courts.¹⁹³ Part of the problem is that some taxpayers are prepared to test the limits in this area.¹⁹⁴ Thus, it is hardly surprising that many cases of tax avoidance continue to reach the courts. Taxpayers who push the boundaries are taking a risk that their arrangement will be caught within the scope of the GAAR, so they should not complain if a court finds that their arrangement is outside Parliament's contemplation.¹⁹⁵

One could argue that this results in an unsatisfactory situation, where some taxpayers who push the boundaries will get away with it and pay less tax, whilst others who take a more cautious approach will be subject to a greater tax burden. This is true in many areas of law where it is not possible to enforce the law every time it is infringed. An example is the offence of "dangerous driving".¹⁹⁶ Similar to the definition of tax avoidance, this standard is not entirely clear, and will be determined on the facts of the case at hand. While not all persons will be caught driving dangerously, this does not mean that there should not be a law against it, or that the Police should not prosecute on occasions where the law has been infringed, on the basis that the standard is vague. This can apply similarly to tax avoidance.

The counter-argument is that in other areas of law where general standards are employed (like "dangerous driving"), there is a sufficient basis on which this concept can be judged. This is because "dangerous driving" is a real world concept which can be resolved on the facts of a case by reference to an external benchmark of driving standards.¹⁹⁷ On the other hand, some provisions in the Income Tax Act have no real-world equivalent, and exist only as a statutory concept, such as PIEs.¹⁹⁸ These are known as "tax concepts".¹⁹⁹ The argument is that when provisions involving "tax concepts" are utilised to gain a tax advantage, the GAAR contains no external benchmark with which we can use to determine if tax avoidance has occurred. Therefore, unlike other areas of law, uncertainty is greater because "tax concepts" lack a real-world benchmark with which they can be compared.

¹⁹³ See Keating and Keating, above n 26.

¹⁹⁴ Ebersohn, above n 10, at 267.

¹⁹⁵ See Littlewood "The Privy Council and the Australasian Anti-Avoidance Rules", above n 180, at 205.

¹⁹⁶ Land Transport Act 1998, s 7(2).

¹⁹⁷ *Improving the Operation of New Zealand's Tax Avoidance Laws*, above n 5, at 9.

¹⁹⁸ At 9.

¹⁹⁹ See *Challenge Corporation (CA)*, above n 6, at 552-553.

Earlier in this chapter,²⁰⁰ it was suggested that it would be difficult to determine whether an arrangement is within Parliament’s contemplation, citing the PIE rules²⁰¹ and *Penny and Hooper* as evidence of this. However, it may not so hard to determine why the PIE rules are within Parliament’s contemplation but the structure employed in *Penny and Hooper* was not. The main difference is that with the PIE rules, Parliament has enacted a specific regime designed to grant a tax advantage, whilst in the latter scenario, Parliament has not legislated to state that those who divert their income through trust structures can pay a lower amount of tax. This tax advantage arises as a natural consequence of the statutory scheme.²⁰² This leaves it open for the GAAR to apply in this situation.²⁰³ However, it is widely accepted that utilisation of the PIE rules to generate a tax advantage is not tax avoidance, as Parliament has specifically provided for a tax advantage to be gained.²⁰⁴

However, the utilisation of a “tax concept” such as the PIE rules could constitute tax avoidance if it is just one individual step in a larger complicated arrangement where elements of artificiality or contrivance are present.²⁰⁵ When individual steps are combined through the use of various statutory provisions, this may no longer accord with what Parliament would contemplate.²⁰⁶ Under the “parliamentary contemplation” test, a court has to look beyond the legal form of the transaction, and examine the true commercial nature of the arrangement (if any), to discover whether tax is a more than incidental factor behind the arrangement.²⁰⁷ In

²⁰⁰ See Chapter Two, Section 3(a) – What is within Parliament’s contemplation?

²⁰¹ See subpart HM of the Income Tax Act 2007.

²⁰² This is because the statutory scheme provides that different tax rates apply to income derived by trustees and individual income earners.

²⁰³ See *Penny and Hooper* (SC), above n 3, at [48], where the Supreme Court cites the select committee report commenting on the PSA rules (Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill (27-2) (select committee report) at 11) for the proposition that “unless the specific rules plainly are intended to cover the field in relation to the use of particular provisions by taxpayers or plainly exclude the use of the general anti-avoidance provision in a certain situation”, then the Commissioner can invoke the GAAR to counter tax avoidance.

²⁰⁴ See *Penny and Hooper* (SC), at [49].

²⁰⁵ See *Ben Nevis*, above n 2, at [105], [107]; *Penny and Hooper* (SC), at [34]. See also Ebersohn, above n 10, at 264-267.

²⁰⁶ Cassidy, above n 13, at 23.

²⁰⁷ This is reflected in tax avoidance jurisprudence. In *Ben Nevis*, above n 2, the fact that there was no real commercial purpose for the arrangement (as it made a loss once the tax impact was excluded), was one of the factors leading to a finding of tax avoidance. In *Dandelion Investments v Commissioner of Inland Revenue* [2003] 1 NZLR 600 (CA) at [84]-[85], the absence of a commercial or business purpose for the arrangement, led to a finding that the scheme had a purpose of tax avoidance. In *Krukziener v Commissioner of Inland Revenue (No 3)* (2010) 24 NZTC 24,563 (HC) the fact that there was no legitimate commercial rationale for Mr Krukziener providing an interest-free advance to himself with no repayment terms led to a finding of tax avoidance.

making this enquiry, a court is examining the commercial purpose and economic substance of the arrangement,²⁰⁸ which are real-world concepts.

Therefore, the contrast with other areas of law due to the lack of an external benchmark in a tax avoidance enquiry is inapt, because the “parliamentary contemplation” test does focus on commercial or other real-world factors motivating a particular arrangement. Nonetheless, tax avoidance may contain a higher level of uncertainty than vague standards in other areas of law, because the opportunities provided to avoid tax are a function of tax laws themselves.²⁰⁹ This makes tax avoidance more uncertain, as one is left with the difficult task of determining when Parliament intends the GAAR to override compliance with a specific statutory provision.

However, this uncertainty can be justified by reference to the particular nature of tax law. Rebecca Prebble and John Prebble note that tax law is unusual in that there are “few other areas of law that people so aggressively try to avoid”. This is enabled further as the nature of tax law means there a large number of loopholes for people to exploit.²¹⁰ When viewed in this light, uncertainty in the “parliamentary contemplation” test is not necessarily a bad thing, given the need for an effective response to this behaviour in order to protect the revenue base.

7. Tax avoidance law cannot prioritise certainty

As demonstrated in this chapter, the “parliamentary contemplation” test does contain a degree of uncertainty and with it, the risk of impressionistic, rather than principled analysis. Certainty is an important aspect of tax law and the tax system. However, this dissertation subscribes to the view that the call for greater certainty in this area of law is over-rated. While the “parliamentary contemplation” test is flawed in some respects, this dissertation is of the view that it contains a justifiable degree of certainty.

There are two main reasons for requiring the GAAR to operate in an uncertain manner. The first is to enable the GAAR to operate effectively to counter tax avoidance. When the scope of the GAAR is read down, sophisticated taxpayers can employ creative ways of

²⁰⁸ See *Ben Nevis*, at [108].

²⁰⁹ *Improving the Operation of New Zealand's Tax Avoidance Laws*, above n 5, at 9.

²¹⁰ Prebble and Prebble, above n 107, at 38.

manipulating the rules in order to reduce their tax burden.²¹¹ In order to be effective, the GAAR needs to operate in a flexible manner,²¹² not specifying exactly which arrangements it will apply to in advance. This ensures that arrangements which are in accordance with all relevant specific provisions, but are outside Parliament’s contemplation can be neutralised. The secondary purpose requires the GAAR to act as a deterrent. By having some uncertainty surrounding the application of the GAAR, taxpayers may be deterred from aggressive tax planning.²¹³

Questions can be asked as to where the line will be drawn in difficult cases such as *Penny and Hooper*,²¹⁴ but it will be hard to provide anything more than a general guide of Parliament’s contemplation due to the wide range of circumstances in which tax avoidance could arise. As the majority in *Ben Nevis* recognised, the “parliamentary contemplation” test “gives as much conceptual clarity as can be reasonably achieved”.²¹⁵ As Littlewood states, the role of the courts in working incrementally towards solutions to difficult cases, is a great strength of the common law.²¹⁶ Through this process, greater guidance will be given over time as to the scope of the GAAR in specific areas. However, requiring courts to anticipate all situations of tax avoidance and produce bright-line rules on the matter is undesirable and impracticable.²¹⁷ Therefore, the law will continue to develop in borderline fact situations, on a case-by-case basis, with additional guidance being provided via statutory enactment or from Inland Revenue when required.

Once we recognise that certainty is not strictly the aim of the exercise, the general nature of the factors which indicate parliamentary contemplation can be viewed in a more favourable light, provided that most taxpayers can determine how their arrangements will be treated by the law.²¹⁸ This dissertation concurs with the Supreme Court’s statement that in most cases, taxpayers should be able to determine the tax treatment of a particular issue.²¹⁹

²¹¹ *Penny and Hooper* (CA), above n 77, at [162], per Hammond J.

²¹² Prebble and Prebble, above n 107, at 41.

²¹³ Keating and Keating, above n 26, at 137; Armstrong, above n 62, at 459; Pagone, above n 94 at 34.

²¹⁴ I characterise *Penny and Hooper* as a difficult case, because of the extent of disagreement between the Judges who heard this case. McKenzie J in the High Court and Ellen France J dissenting in the Court of Appeal, were of the view that the taxpayer’s business structure did not constitute tax avoidance. The majority of the Court of Appeal and the Supreme Court were of the opposite view.

²¹⁵ *Ben Nevis*, above n 2, at [112].

²¹⁶ Littlewood “Tax Avoidance, the Rule of Law and the New Zealand Supreme Court” above n 25, at 68.

²¹⁷ *Penny and Hooper* (CA), above n 77, at [162], per Hammond J.

²¹⁸ Freedman “Defining taxpayer responsibility”, above n 18, at 346, 356.

²¹⁹ At [112].

Taxpayers can gain guidance in several ways. There is a lot of case law and Inland Revenue guidance on specific areas already available to taxpayers and their advisors. In addition, it may be wise for a taxpayer to obtain a binding ruling, if the cost is outweighed by the benefits of gaining certainty. Many ordinary transactions will be within Parliament's contemplation as transactions which are driven only by commercial imperatives (as opposed to tax purposes) are unlikely to produce tax consequences outside the scope of the legislation.²²⁰ The uncertainty remaining in the few remaining marginal cases can be justified in light of the need for the GAAR to operate effectively and due to the inherently uncertain nature of tax avoidance. A large number of cases continuing to hit the courts does not necessarily indicate extensive uncertainty in the "parliamentary contemplation" test, but demonstrates taxpayers' willingness to continue operating close to the boundaries of the law.²²¹

This dissertation does not view certainty as undesirable but that in the particular context of tax avoidance, the need for certainty has to be balanced against other factors. Therefore, a justifiable level of certainty is one that is sufficient to provide taxpayers with a reasonable level of guidance, rather than being an overriding concern in any tax avoidance dispute. This dissertation is of the view that the "parliamentary contemplation" test has achieved this level of certainty. While this test does not bring complete clarity in the law of tax avoidance, devising a test which achieves this would be a herculean, and some would suggest, an impossible task. In this inherently uncertain area of law, some taxpayers will aggressively try to utilise loopholes in the law. This justifies a less certain approach, which is needed to effectively counter this behaviour and protect the tax base.

The following chapter will focus on the application of the "parliamentary contemplation" test to the use of company/trust structures to gain a tax advantage. This chapter centres on the Supreme Court's decision in *Penny and Hooper*, and will analyse the key factors behind the decision. This analysis is aimed at practically applying the discussion about certainty from this chapter to the factual scenario in *Penny and Hooper*. This is done to determine whether a sufficient level of certainty is provided in this context by retaining some flexibility in the application of this test, whilst providing taxpayers with a reasonable level of guidance.

²²⁰ *Glenharrow Holdings Limited v Commissioner of Inland Revenue*, above n 136, at [49]. While one could point to *Penny and Hooper* as providing an example of an ordinary transaction which is outside Parliament's contemplation, the fact that it was motivated solely by tax purposes rendered it outside Parliament's contemplation.

²²¹ Ebersohn, above n 10, at 267-269.

CHAPTER THREE: APPLICATION OF THE “PARLIAMENTARY CONTEMPLATION” TEST TO COMPANY/TRUST STRUCTURES

1. *Penny and Hooper*

(a) The facts

This case involved two orthopaedic surgeons who employed similar structures in the operation of their orthopaedic practices. Messrs Penny and Hooper restructured their separate businesses by selling their practices to a company owned by the trustees of their respective family trusts. Following the restructuring, each practice operated in a similar manner to how it had done before. In both instances, each taxpayer was the sole director and became an employee of their company.²²² Both were beneficiaries of their family trust,²²³ along with their spouses, children and grandchildren. The family solicitor and accountant were appointed as trustees in both instances.²²⁴

Mr Penny’s business structure contained a few different features. He re-structured his practice several years before the change in the top marginal tax rate, but lowered his salary once the top marginal income tax rate increased to 39% from 1 April 2000.²²⁵ Once this step was taken, the family trust began to lend him money on favourable terms (no interest or repayment date), representing a large proportion of the funds distributed to the family trust by the company.²²⁶ The following diagram sets out Mr Penny’s business structure:²²⁷

²²² *Penny and Hooper (SC)*, above n 3, at [1].

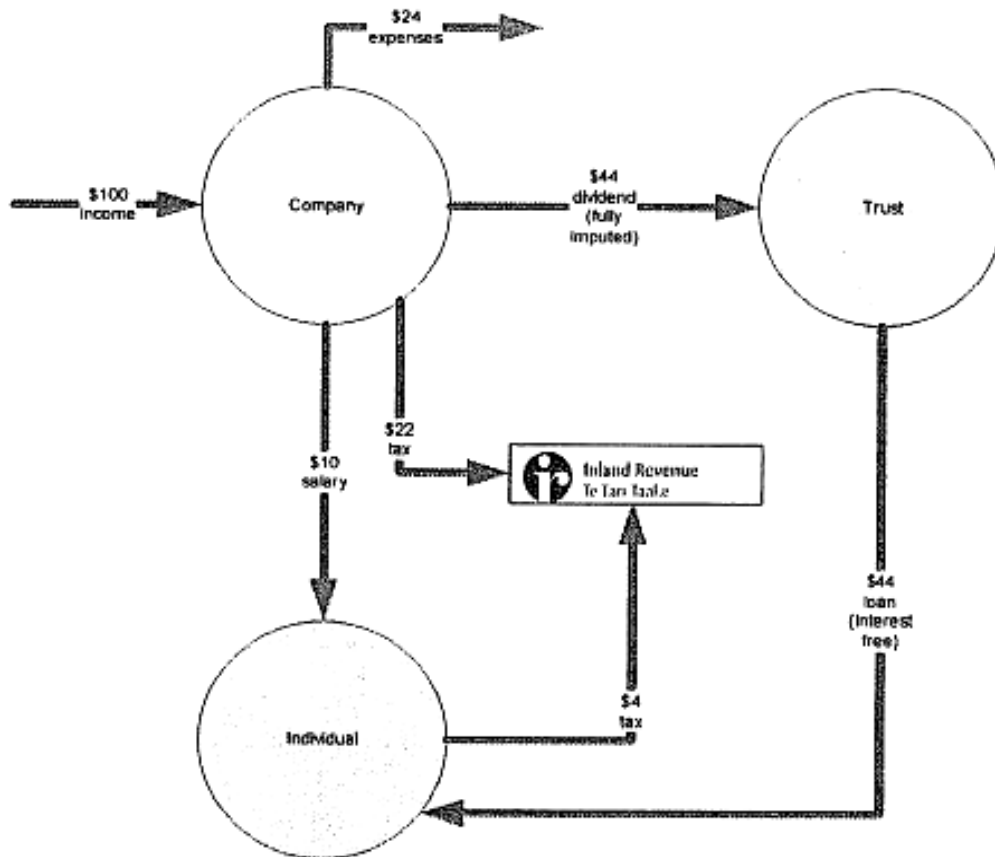
²²³ Except Mr Hooper to the extent that he was not a beneficiary of the mirror trust he settled (as Mr Hooper and his wife settled mirror trusts which each owned roughly a half share of the company).

²²⁴ At [8], [13].

²²⁵ At [3].

²²⁶ At [3].

²²⁷ This diagram is from Lennard “Orthopod’s Arrangements”, above n 40, at 43-44.



Following the increase in the top marginal income tax rate, both taxpayers made the decision as directors of the company to reduce the salary paid to themselves as employees. The salary paid to each taxpayer was substantially below the net earnings generated by each practice. Mr Hooper was paid a salary of \$120,000 between 2001 and 2004, yet the net earnings of his practice were between \$556,000 and \$712,000.²²⁸ Mr Penny was paid \$100,000 and the net earnings of his practice were between \$655,000 and \$832,000.²²⁹ Both accepted that they would not agree to such low salaries if they were employed by an unrelated company.²³⁰ A commercially realistic salary²³¹ was estimated to be around \$538,000 for Mr Hooper and \$633,000 for Mr Penny.²³²

²²⁸ At [9].

²²⁹ At [14].

²³⁰ *Penny and Hooper* (CA), above n 77 at [19], [30].

²³¹ The level of a commercially realistic salary was calculated by Mr Lyne, a specialist investigating accountant based on the earnings which a specialist could derive in private practice operating as a sole trader, less an allowance for the return a third party owner would expect to receive from the practice to cover expenses, contingencies, and to provide an adequate return on capital invested. See *Penny and Hooper* (HC), above n 159 at [51], per McKenzie J. The basis for calculating this salary was not challenged in the Court of Appeal. See *Penny and Hooper* (CA) at [40].

²³² *Penny and Hooper* (CA), at [38], [39].

This structure resulted in considerable tax benefits for the taxpayers. This is because the majority of income earned by the company was distributed to the family trust as a dividend (rather than being paid to the taxpayers as salary), and tax was paid on this income at the trustee rate of 33%, rather than the top marginal tax rate for income earners of 39%, had that income been derived by Messrs Penny and Hooper directly as salary.

(b) The Supreme Court’s decision

The Supreme Court was unanimous in holding that these company/trust structures were tax avoidance arrangements. There was no issue that all the specific statutory provisions had been complied with, so the Court moved straight to the second stage of the “parliamentary contemplation” test.²³³ The main reason for both structures being outside Parliament’s contemplation was that the salaries were paid at an artificially low level which was motivated primarily by tax considerations.²³⁴ A further important factor was that the taxpayers indirectly retained the use of these funds without paying a higher incidence of tax. This was through loans being made on favourable terms (Mr Penny), or indirectly receiving the benefit of funds applied to the family home and holiday home (Mr Hooper).²³⁵

While other purposes of the arrangement included protection of assets from professional negligence claims and a desire to build up assets to benefit their family, the Supreme Court concluded that tax avoidance was a more than “merely incidental” purpose or effect of the arrangement.²³⁶ There was a specific anti-avoidance provision (the PSA rules)²³⁷ designed to counter the use of company/trust structures. This provision did not apply on these facts.²³⁸ Despite the existence of a specific anti-avoidance provision dealing with a similar issue, the Court held that the Commissioner was not prohibited from relying upon the GAAR to counter the taxpayer’s arrangement. The Supreme Court held that the GAAR can be applied

²³³ At [33].

²³⁴ At [34], [36].

²³⁵ At [35], [47].

²³⁶ At [36].

²³⁷ Income Tax 2007, ss GB 27–GB 29. These rules attribute the income of a company to the individual taxpayer if 80% or more of the company’s income is derived from a single source.

²³⁸ These rules did not apply because the taxpayers’ businesses received income from a number of different customers.

whenever the specific provision is not clearly intended to cover the field in that particular area, or where the provision does not specifically exclude the operation of the GAAR.²³⁹

Despite the taxpayer's protestations that this was a common, widely used structure, the Court held that the Act requires that taxpayers do not structure their arrangements in a way in which a tax avoidance purpose is more than "merely incidental", unless it was within Parliament's contemplation.²⁴⁰ The Supreme Court upheld the majority of the Court of Appeal's finding that this was a tax avoidance arrangement.

(c) Importance of this decision

While the particular issue in this case is currently not applicable, given the alignment of the top marginal income tax rate with the trustee rate at 33%, this decision is still significant. As indicated from the submissions made by the taxpayers during the course of this trial,²⁴¹ it is clear that these taxpayers along with many others²⁴² thought that they could utilise these structures in their businesses and pay salaries at below arms-length levels, without the Commissioner of Inland Revenue challenging these arrangements. When put in the context of previous Privy Council decisions involving company/trust structures where tax was reduced by diverting income to a trust, it is not as surprising that the Supreme Court made the decision it did.²⁴³

²³⁹ At [48]. This overrules the proposition from the majority of the Court of Appeal in *Challenge Corporation* above n 6, at 542-544, per Cooke J; 554-555, per Richardson J, that the GAAR is excluded from operating, whenever a specific anti-avoidance provision exists in a particular field but does not apply in the case at hand.

²⁴⁰ At [49].

²⁴¹ See *Penny and Hooper* (CA), at [96]-[99], *Penny and Hooper* (HC), above n 159, at [13].

²⁴² In her dissenting judgment, Ellen France J in *Penny and Hooper* (CA), above n 77, at [181], stated that the everyday nature of this transaction pointed against this structure being an artificial tax avoidance scheme. It was not just Messrs Penny and Hooper who entered into this type of business structure, indicating that many taxpayers felt that such arrangements were acceptable from a tax point of view. Following this decision, as of 5 October 2012, over 170 taxpayers had made voluntary disclosures to Inland Revenue of tax positions which were broadly similar to *Penny and Hooper*. See Stuff "IRD extends income diversion amnesty" (10 October 2012) <<http://www.stuff.co.nz/business/small-business/7797528/IRD-extends-income-diversion-amnesty>>.

²⁴³ These cases include *Peate v Commissioner of Taxation of Commonwealth of Australia* [1964] 111 CLR 443, [1967] 1 AC 308 (PC). In this case a similar company/trust structure to *Penny and Hooper* was employed. The Privy Council affirmed the High Court of Australia's finding that the arrangement's main purpose was to avoid tax; despite other reasons being listed for the re-structuring (at 476, per Taylor J). Another case was *Mangin v Commissioner of Inland Revenue*, above n 33, where a trading trust arrangement was employed in which the taxpayer leased the most profitable part of his farming land to the family trust on an annual basis with different paddocks being leased to the trust every year. This had the effect of the income received from the harvest of crops on that parcel of land, being diverted to the beneficiaries of the trust instead of the taxpayer, and tax was paid at a lower rate. Due to crop rotation, the trading trust received most of the revenue from each year's harvest. The Privy Council held that this arrangement had the sole purpose of avoiding tax (at 840, per Turner J). See Lennard "Orthopod's Arrangements", above n 40 at 46, who states that despite some differences between

This decision is still applicable in other cases where tax arbitrage is an issue.²⁴⁴ Furthermore, should Parliament decide to increase the top marginal tax rate in the future, this decision would remain applicable. This is likely even if Parliament specifically legislates to counter the structure employed in *Penny and Hooper*, as it would be difficult for Parliament to legislate to cover all instances where company/trust structures are employed to gain a tax benefit.

(d) How does the decision in *Penny and Hooper* align with the approach taken by the Supreme Court in *Ben Nevis*?

The key difference between the two cases is that *Ben Nevis* dealt with a situation where specific statutory provisions were employed, whereas *Penny and Hooper* was a tax arbitrage case where no specific statutory provisions were utilised to gain a tax advantage. Instead, the taxpayers gained a tax advantage through adopting a structure which incurred a lower incidence of tax. Despite these differences, the Supreme Court affirmed the “parliamentary contemplation” test in *Penny and Hooper*,²⁴⁵ confirming that this is the main approach to be applied in tax avoidance cases.

The “parliamentary contemplation” test will apply differently in tax arbitrage cases. As there are no specific statutory provisions to focus on, a court can move straight to the second step to identify whether there are factors which identify the arrangement as being artificial or contrived. In *Penny and Hooper*, the lack of a commercially realistic salary was the factor indicating artificiality.²⁴⁶ This is consistent with the approach taken in earlier tax avoidance cases where there were no specific statutory provisions in issue.²⁴⁷

this case and *Penny and Hooper*, these differences do not suggest that a different outcome should result in *Penny and Hooper*.

²⁴⁴ One can contemplate situations involving the use of a company structure to pay less tax as the current company tax rate is set at 28%. In addition, company/trust structures can still be used to gain a tax advantage, if distributions are made to those who have a lower marginal rate of tax – such as spouses, or children over the age of 18.

²⁴⁵ At [33].

²⁴⁶ At [33].

²⁴⁷ Lennard “Orthopod’s Arrangements”, above n 40, at 7-8. These cases include: *Hadlee v Commissioner of Inland Revenue* [1991] 2 NZLR 517 (CA); *Mangin v Commissioner of Inland Revenue*, above n 33; *Dandelion Investments v Commissioner of Inland Revenue*, above n 207.

(e) Application of the “parliamentary contemplation” test in *Penny and Hooper*

The following sections will examine the main determinants for the taxpayers’ business structure being outside Parliament’s contemplation. The primary reason was that salaries were paid at an artificially low level which was not commercially realistic. This factor, coupled with other features of the arrangement which included the lack of justification for the lower salary paid, and the fact that structure allowed the taxpayers to retain the benefits of income generated by their professional practices without incurring a higher incidence of tax, led to a finding of tax avoidance.²⁴⁸ These factors are key indicators of Parliament’s contemplation in a tax arbitrage case where company/trust structures are employed. Therefore, it is important that taxpayers are aware of their scope, while keeping in mind that this guidance can only be general in nature so it can be applicable to a wide range of factual circumstances in which company/trust structures are employed.

2. Level of salary

(a) How does a taxpayer determine a commercially realistic salary?

Faced with this decision, taxpayers need to be able to determine what a commercially realistic salary is. The Supreme Court did not expand on the factors which are considered in deciding whether a salary is commercially realistic. Pagone states that determining a commercially realistic salary may depend on the impact that the evidence has on the decision maker, resulting in some differences of opinion.²⁴⁹ In *Penny and Hooper*, salaries of around \$100,000 were not commercially realistic. But would a salary of \$400,000 been acceptable?

Concerns about the uncertainty of this notion can be mitigated to some degree as taxpayers can gain guidance in various ways. There is authority to suggest that if taxpayers employ a realistic basis for estimating a salary, a court would be likely to find that the salary is commercially realistic.²⁵⁰ In many industries, taxpayers can determine the level of a commercially realistic salary, by examining market data and industry benchmarks. However

²⁴⁸ At [34]-[36].

²⁴⁹ Pagone, above n 94, at 37.

²⁵⁰ See *Case W33* (2004) 21 NZTC 11,321 at [69], [75], where Barber J suggests that a commercially realistic salary can be indexed or related to the fees generated by the company, or calculated on another appropriate basis which makes an allowance for the costs of employing support staff and a return on investment capital in the business.

this information may not be available to all taxpayers.²⁵¹ An alternative method involves fixing a market salary based on a percentage of the total fees generated.²⁵²

Inland Revenue has indicated that it will be unlikely to interfere in situations where the total salary received by the individual service provider is more than 80% of the total distributions received by trustees and associated family entities.²⁵³ In *Penny and Hooper*, this was the method used to calculate the level of a commercially realistic salary which should have been paid. While the Commissioner's statements are not binding,²⁵⁴ this does provide some guidance for taxpayers when determining the level of salary to pay, as the Commissioner would be highly unlikely to challenge a taxpayer's assessment in marginal circumstances,²⁵⁵ where the amount of tax revenue to be gained is relatively small.²⁵⁶ While this notion is not entirely clear, taxpayers have some guidance on which to base salary decisions.

(b) Reasons for not paying a commercially realistic salary

Penny and Hooper does not stand for the principle that if the salary level in a family-owned company is not arms-length, it is automatically a tax avoidance arrangement.²⁵⁷ The Supreme Court pointed out that it is the combination of salary level and other features of the structure which need to be examined.²⁵⁸ If other features of the arrangement provide justification for a lower salary, then the arrangement will not have the purpose of tax avoidance. This reflects

²⁵¹ For example, in *Penny and Hooper* it was difficult to determine a commercially realistic salary for a self-employed orthopaedic surgeon due to the lack of comparable market information on the amount of salary which is paid to such individuals.

²⁵² This will be more appropriate for service businesses in situations where the main driver of the firm's revenue is due to the personal attributes and skill of the owners of the business. See Inland Revenue *Revenue Alert RA 11/02* (Legal & Technical Services, 1 September 2011) at 3-4. This method of calculation has been criticised by Lennard "Orthopod's Arrangements", above n 40 at 45-46, on the basis that most employees' salaries do not constitute a profit share.

²⁵³ *Revenue Alert RA 11/02* at 4.

²⁵⁴ See *O'Neil v Commissioner of Inland Revenue* [2001] UK PC 17 at [26]-[27].

²⁵⁵ See *Penny and Hooper* (CA), above n 77, at [126], per Randerson J.

²⁵⁶ This is because Inland Revenue has limited resources so tends to direct its attention to instances where it can gain more tax revenue. It is recognised that it is not ideal that a member of the Executive (Inland Revenue) is effectively applying the law in this area by using its discretion to suggest where it will and will not intervene in relation to salaries being paid in a family business arrangement, rather than this being set out by Parliament. However, Inland Revenue's guidance is noted for the simple fact that in practice, the guidance provided by Inland Revenue will lessen concerns about uncertainty in this area.

²⁵⁷ See *Penny and Hooper* (CA), above n 77, at [125]. This proposition is also accepted by Courtney J in *Krukziener v Commissioner of Inland Revenue (No 3)*, above n 207, at [42], who recognises that the taxpayer in that case, could have justified paying a below-market salary, or no salary at all, pending completion of a property development project.

²⁵⁸ At [34].

the wording of the GAAR which requires tax avoidance to be a more than “merely incidental” purpose.²⁵⁹

What are the features which can counter a finding of tax avoidance? The Supreme Court stated that a commercially realistic salary does not have to be paid when funds are needed to provide for upcoming financial difficulties, or for capital expenditure.²⁶⁰ In *White v Commissioner of Inland Revenue*,²⁶¹ a company/trust structure with similar features to *Penny and Hooper* was employed. The one important difference was that the company (owned by the family trust), ran a profit-making anaesthetist operation and a loss-making orchard. At the time the arrangement was established, it was expected that there would be sufficient profits to pay a salary to Dr White, but an unexpectedly poor harvest caused the orchard to make a loss.²⁶² The income generated by the anaesthetist business was used to pay the orchard’s debts, and there were insufficient funds to pay Dr White any salary. Heath J stated that the lack of funds was a sufficient reason for holding that the purpose of the arrangement was not tax avoidance.²⁶³

This case raises the question as to whether a situation where a company has two businesses – a profit-making venture, and an operation which unlike *White* is *expected* to make losses,²⁶⁴ would constitute tax avoidance. The Income Tax Act allows a group of companies to subtract the tax losses made by one entity from the net income made by another entity, if certain requirements are met.²⁶⁵ Such an arrangement would be within Parliament’s contemplation, provided that the losses incurred are real and not contrived.²⁶⁶ In *Ben Nevis*, the claimed tax losses were artificial and contrived because there was a large timing difference between when expenditure was incurred and when it would be paid, and the ultimate profitability of the arrangement was doubtful. This raised serious questions over whether the arrangement had a true business purpose, as opposed to a tax avoidance purpose.²⁶⁷ If there is no commercial

²⁵⁹ Income Tax Act 2007, s YA 1: Definition of “tax avoidance arrangement”.

²⁶⁰ At [34]. Inland Revenue has also provided a list of valid commercial reasons for paying a lower salary which include, setting profits aside to acquire business assets or adverse business conditions which reduce the amount of profit available to be distributed: See *Revenue Alert 11/02*, above n 252.

²⁶¹ *White v Commissioner of Inland Revenue* (2010) 24 NZTC 24, 600.

²⁶² At [74].

²⁶³ At [55], [69], [71], [75].

²⁶⁴ An example is an investment in a forest scheme which makes tax losses for a long period of time until the timber is eventually harvested.

²⁶⁵ See Income Tax Act 2007, Subpart IC.

²⁶⁶ *White* at [69].

²⁶⁷ *Ben Nevis*, above n 2, at [122], [127]-[130].

justification for an arrangement, tax avoidance is likely to be a more than “merely incidental” purpose of the arrangement, rendering it outside Parliament’s contemplation.²⁶⁸

3. Retaining the benefit of the funds

(a) Analysis of the Supreme Court’s reasoning

A key feature which led to the arrangement being outside Parliament’s contemplation (in combination with the low salary), was that the structure enabled the taxpayers to retain the full benefit of income received from their practices, without incurring a higher tax rate.²⁶⁹ These benefits were receiving loans on favourable terms (Mr Penny) or gaining the benefit of funds applied to the family home and holiday home (Mr Hooper).²⁷⁰ If this feature were not present, tax avoidance may only be an incidental purpose of the arrangement,²⁷¹ even if a tax advantage were obtained.²⁷² If the taxpayer is not receiving the fruits of their labour through distribution of trust funds to themselves or their family, one could argue that other factors (such as providing for future capital expenditure) are of sufficient weight to render tax avoidance a “merely incidental” purpose. An arrangement where tax avoidance is “merely incidental” is likely to be outside Parliament’s contemplation.²⁷³ However the fact that family members are benefitting from the application of the trustees’ discretion, as in Mr Hooper’s case,²⁷⁴ should be enough to infer that the individual taxpayer is also gaining a benefit, putting the arrangement outside Parliament’s contemplation (assuming a low salary has also been paid).

In both instances, Messrs Penny and Hooper were beneficiaries, and the Supreme Court stated that they could expect the trustees to benefit them, despite not being trustees

²⁶⁸ At [114].

²⁶⁹ *Penny and Hooper* (SC), above n 3, at [34]-[35].

²⁷⁰ At [35], [47].

²⁷¹ See Income Tax Act 2007, s YA 1: Definition of “tax avoidance arrangement”.

²⁷² One can foresee two circumstances in which a tax advantage could still be obtained. The first is where funds are retained in trust, rather than being distributed. In this instance, tax would be paid at the trustee rate, rather than the top marginal income tax rate, had those funds been distributed to beneficiaries immediately. Even if funds are distributed later on and tax is paid at the top marginal income tax rate, the taxpayer benefits through a timing advantage by not paying the extra 6% of tax when that income is originally received by the trust. The second circumstance is where trust funds are distributed to adult beneficiaries who have a lower marginal rate than the top marginal tax rate, rather than trust funds being paid as salary and taxed at the taxpayer’s marginal income tax rate.

²⁷³ *Ben Nevis*, above n 2, at [114].

²⁷⁴ Family members benefitted through using the family home and holiday home, to which trust funds were applied. It is also likely that Mr Hooper was indirectly benefitting from the application of funds for this purpose.

themselves.²⁷⁵ This statement shows some disregard for the legal form of the trust, and ignores trustees' duty to all beneficiaries to act independently.²⁷⁶ This may not be solely motivated by tax concerns. It may also reflect the willingness of New Zealand courts to "look through" trusts²⁷⁷ in response to concerns about the extent of control that settlors have over assets held in trust.²⁷⁸ In doing this, the Court is not directly interfering with basic trust principles, but is making a decision in the particular context of tax avoidance, where differing considerations apply. This is because the GAAR is not confined to looking at the legal form of transaction, but is directed towards examining the purpose of an arrangement.²⁷⁹

(b) When can the taxpayer expect to benefit from the exercise of the trustees' discretion?

This enquiry could be answered simply by looking at what purposes the trustees applied trust funds to and asking whether the taxpayer obtained a benefit from this. However if funds were retained by the company or trust, this is less clear. In this scenario, it is more difficult to argue that the taxpayer could expect to benefit as a result of the application of the trustees' discretion when that discretion has not been exercised. Under conventional trust principles, a discretionary beneficiary only has a right to be considered by the trustees, but no expectation that the trustees will exercise their discretion in their favour.²⁸⁰ It is unclear why the Supreme Court thought that Messrs Penny and Hooper could expect the trustees to act as they did. It is possible that the Supreme Court inferred from the fact that they selected the trustees, that they would expect them to exercise their discretion in their favour.²⁸¹

This indicates that the Supreme Court is willing to examine the reality of the situation and find an expectation of benefit in situations where the settlor has retained some control over the company/trust structure despite being a discretionary beneficiary. For example, one

²⁷⁵ At [35].

²⁷⁶ This analysis assumes that the trustees will favour some beneficiaries over others, and will always exercise their discretion in their favour. See Jessica Palmer "Equity and Trusts" (2012) 1 NZ L Rev 141 at 150.

²⁷⁷ For example, see *Walker v Walker* [2007] NZCA 30, [2007] NZFLR 772 at [49], [60]; *Harrison v Harrison* (2008) 27 FRNZ 202 (HC); *B v X [Child support]* [2011] NZFLR 481 (HC) (currently on appeal); *Petrecevic v Legal Services Agency* [2011] 2 NZLR 802 (HC).

²⁷⁸ See Law Commission *Some Issues with the Use of Trusts in New Zealand: Review of the Law of Trusts Second Issues Paper* (NZLC PP20, 2010) at 52-53. The courts have also been more willing to "look through" trusts because the test for what constitutes a sham trust has been set relatively high by the Court of Appeal. See *Official Assignee v Wilson* [2008] 3 NZLR 45 (CA)

²⁷⁹ See *Ben Nevis* at [109].

²⁸⁰ *Gartside v Inland Revenue Commissioners* [1968] 1 All ER 121, [1986] AC 553 (HL) at 617-618.

²⁸¹ *Penny and Hooper* (SC), above n 3, at [35]. This analysis is problematic because it assumes that the trustees will be willing to breach their fiduciary duty to act independently towards all beneficiaries. This dissertation does not attempt to address this problem, as it is aimed outlining the approach that the Supreme Court has taken in this area.

would think that a settlor who retains the power to appoint and remove trustees, in addition to their discretionary interest would have a sufficient expectation of benefit. This is because they could simply remove any trustees who do not exercise their discretion as they wish. It is less clear where a settlor does not have these powers. According to *Penny and Hooper*, the fact that the taxpayer has selected the trustees might be enough.²⁸²

By contrast, if a taxpayer does not have a beneficial interest in trust property, a court is more likely to hold that they cannot expect to benefit from the exercise of the trustees' discretion,²⁸³ because the trustees cannot apply income or capital directly to the taxpayer (unless the trust deed can be altered to include the taxpayer). However, this finding cannot be ruled out if trustees are exercising their discretion in favour of close family members.²⁸⁴

This leaves some room for uncertainty as to the circumstances in which a court will find that a taxpayer can expect to benefit. Ultimately, it is suggested this may come down to a consideration of the individual circumstances of a case, looking at how the company/trust structure was established, any rights and powers that the taxpayer has retained in the trust deed, along with the relationships between the parties.²⁸⁵

(c) Identification of the benefit

Even if we can identify how the trustees have exercised their discretion, we still have to determine whether the individual taxpayer has benefitted from this. Mr Hooper's arrangement demonstrates that the taxpayer does not necessarily need to have trust funds applied directly to themselves for a benefit to be gained. Even if Messrs Penny and Hooper were not beneficiaries, application of trust funds to support close family members, or to family assets (such as the family home in Mr Hooper's case), would indirectly benefit them, as they would otherwise fund this expenditure themselves. The question is: How weak can the link between the individual taxpayer and the benefit get, before you could say that the taxpayer is not truly benefitting from the application of the trustees' discretion?

²⁸² At [35].

²⁸³ See *Loader v Commissioner of Inland Revenue* [1974] 2 NZLR 472. This case also involved a company/trust business structure. However Cooke J found in favour of the taxpayer, by holding that there was no tax avoidance arrangement. This case was distinguished in *Penny and Hooper* (SC) at [53], because there were some non-tax related reasons for the re-structuring, in addition to the fact that the taxpayer had no beneficial interest in the trust property. This suggests that whether the taxpayer has a beneficial interest in the trust property will be a key determinant in a tax avoidance enquiry involving company/trust structures.

²⁸⁴ See Section 3(c) – Identification of the benefit.

²⁸⁵ *Ben Nevis*, above n 2, at [108].

There will be circumstances where it is not apparent whether a taxpayer is benefitting from the application of the trustees' discretion. For example, say a child over the age of 16 is distributed trust funds for educational purposes. In these circumstances, a tax benefit could be obtained.²⁸⁶ Does a related taxpayer (i.e. parent of that child) benefit from the application of the trustees' discretion in this instance? Unlike a minor, a parent has no duty to support their child but may choose to provide assistance. If the parent would otherwise fund that education, they receive an indirect benefit. This could depend on the person's age, as a court would be more likely to infer that a parent would fund the education of a younger person (i.e. closer to 16), than an older child who is able to support themselves during tertiary study. The closeness of the link between the taxpayer and person receiving funds is also relevant. A taxpayer is less likely to fund a grandchild or nephew's education. Therefore, a court would be less willing to infer that the taxpayer benefitted when the trustees' discretion is exercised in favour of those family members, than for the taxpayer's own children.

This analysis demonstrates the difficulties in proving that a taxpayer actually benefitted from the exercise of the trustees' discretion. The more remote the benefit is from the individual taxpayer, in terms of their link to the person benefitting (family tie and nature of their relationship), or the particular purpose to which the funds are applied (e.g. education); the harder it is to argue that the taxpayer retained the benefit of the use of trust funds. This might seem like a purely academic question. However, it is likely that taxpayers will try to find ways of structuring their businesses to avoid the impact of the decision in *Penny and Hooper*. Therefore understanding the scope of this decision is of practical importance to both taxpayers and Inland Revenue. If this element is not present, then *Penny and Hooper* may not apply, as the payment of a low salary by itself, is insufficient to place an arrangement outside Parliament's contemplation. This is because the Supreme Court emphasised that the question of whether the level of salary constitutes tax avoidance will depend on its effect in combination with other features of the structure.²⁸⁷

²⁸⁶ A tax benefit will be obtained, assuming that the beneficiary is taxed on their personal income at a rate below the (now) top marginal tax rate of 33%. Any distributions made to this taxpayer are taxed at a lower rate, than if trust income was applied to a minor beneficiary who is under 16 (as they are taxed at the trustee rate of 33% in accordance with sections HC 35 – HC 37, Income Tax Act 2007), or if the income was distributed to the persons whose efforts are primarily responsible for generating the income received by the company via payment of salary (as income above \$70,000 is taxed at the top marginal tax rate of 33%).

²⁸⁷ At [34]-[35].

4. Is there a sufficient level of certainty in this context?

At first glance, the application of the “parliamentary contemplation” test in *Penny and Hooper* raises more questions than answers. The Supreme Court has not given further indication as to the scope or application of the factors which led to a finding of tax avoidance. The fundamental question arising from this decision is: Which company/trust structures are within Parliament’s contemplation, and which ones are not? This analysis is quite fact dependent.²⁸⁸ Before this case was decided, it was unclear whether the GAAR would apply in this fact situation. However, this dissertation is of the view that the Supreme Court’s decision provides taxpayers with a reasonable level of guidance on when the use of company/trust structures will constitute tax avoidance, and contains a sufficient level of certainty.

It is clear that a commercially realistic salary has to be paid in absence of reasons to justify paying a lower salary. Pagone is partially correct in that there may be some differences in opinion over the level of salary,²⁸⁹ but these differences are not so great to render this concept unachievable. In many situations, it will be possible for a taxpayer to determine this by reference to market information. When such information cannot be gathered, a taxpayer can err on the side of caution by paying 80% of business profits as salary in accordance with *Penny and Hooper* and reinforced by Inland Revenue’s guidance.²⁹⁰

Some reasons for a lower salary level have been provided by the Supreme Court and Inland Revenue. It would be difficult to provide taxpayers with a complete list of reasons. Most of the main instances where a company/trust structure is employed for a purpose other than tax avoidance are provided for. This again reaffirms that uncertainty in this area is restricted to the margins,²⁹¹ as there are only likely to be rare situations where there are non-tax reasons justifying a *Penny and Hooper* type structure, which have not already been provided for by the courts or Inland Revenue.

Some uncertainty is generated because the Supreme Court stated that an arrangement can have a tax avoidance purpose in some years but not others, depending on the purpose or effect of the step taken on each occasion.²⁹² Dissenting in the Court of Appeal, Ellen France J highlighted her concerns by pointing out that what a taxpayer does “in one year may be

²⁸⁸ See *Ben Nevis*, above n 2, at [102], [108].

²⁸⁹ Pagone, above n 94, at 37.

²⁹⁰ *Revenue Alert 11/02*, above n 252.

²⁹¹ See *Ben Nevis*, above n 2, at [112].

²⁹² At [34].

within acceptable bounds but a different position may pertain in the next.”²⁹³ In some years, a low salary will not constitute tax avoidance if there are reasons which justify a lower salary such as financial difficulty, but in other years, a low salary will ordinarily constitute tax avoidance.²⁹⁴ The concern is that it may be difficult to assess and will require a constant year-by-year assessment by the taxpayer.

These concerns are overstated. There is nothing in the definition of “arrangement”,²⁹⁵ to suggest that you only assess the purpose of tax avoidance at the time the arrangement is established. Furthermore, a year-by-year assessment is a pragmatic approach to ensure that the GAAR can operate effectively in countering tax avoidance. If an arrangement can only be assessed for tax avoidance in the year it is adopted, but not in subsequent years when individual steps or circumstances have changed (e.g. salary levels are lowered), taxpayers would be encouraged to adopt legitimate business structures then alter them in future years in order to avoid tax.²⁹⁶ This is not an acceptable outcome.

A year-by-year assessment of the purpose of an arrangement ensures that tax avoidance can be effectively countered in this area. This reflects Parliament’s purpose that while company/trust structures are legitimate, they may not be in future years if artificial steps are added which have the effect of avoiding tax.²⁹⁷ Concerns about uncertainty are lessened because there is a presumption that when these structures are employed, a commercially realistic salary must be paid in absence of a justification for paying a lower salary.²⁹⁸ Assuming that a taxpayer can determine the level of a commercially realistic salary in most instances, uncertainty surrounding the notion of a commercially realistic salary is restricted to situations where a justification for paying a lower salary may be present.

The Supreme Court did not elaborate on when a taxpayer is deemed to secure the benefit of the use of funds received by the trustees. However, one can easily infer some of the situations where a taxpayer could expect to benefit. It is likely that where trust funds have been applied to the individual taxpayer, someone closely related to the taxpayer, or towards property which the taxpayer’s family uses, a court will infer that the taxpayer is indirectly benefitting from the exercise of the trustees’ discretion. Any powers which the taxpayer retains in the

²⁹³ *Penny and Hooper* (CA), above n 77, at [183], per Ellen France J.

²⁹⁴ *Penny and Hooper* (SC), above n 3, at [34]; *White*, above n 261.

²⁹⁵ Income Tax Act 2007, s YA 1.

²⁹⁶ See *Case V20* (2002) 20 NZTC 10,233 at [132], *Case W33*, above n 250, at [71].

²⁹⁷ *Penny and Hooper* (SC) at [33].

²⁹⁸ At [34]; *Penny and Hooper* (CA) at [126], per Randerson J.

trust deed will be relevant when trust funds have not been distributed. Given the Supreme Court's willingness to ignore the legal form of a trust and examine the reality of the situation,²⁹⁹ this requirement should be relatively easy to satisfy in practice.

Because there are many instances where tax avoidance could arise in the use of company/trust structures, it is difficult for Parliament or the courts to lay down guidelines or rules which apply to every fact situation. *White* provides an example of how slightly differing factual circumstances can lead to an opposite conclusion on the issue of tax avoidance. This is why the decision in *Penny and Hooper* has been delivered in quite general terms with notions such as "commercially realistic salary" being used. This will necessitate a factual enquiry, which is commonplace in the area of tax avoidance. Borderline cases³⁰⁰ may remain difficult to determine in advance. There will always be uncertainty around the edges due to the simple inability of rules to provide complete guidance on whether the use of a particular company/trust structure falls inside Parliament's contemplation.

If a specific anti-avoidance provision was enacted in this area, many taxpayers would try to structure their affairs in a deliberate attempt to avoid the new rule. For example, Parliament could enact a new provision to counter *Penny and Hooper* which states that any taxpayer who employs a company/trust structure in their business must pay 80% of profits as salary to themselves, if their efforts substantially generate the income of that business. This provision would only apply when the taxpayer is a beneficiary of the trust, and a related party (for example, trustees of the family trust) is a majority shareholder in that company. Taxpayers could avoid this rule by not being a beneficiary of the trust, but ensure they still benefit through trust funds being distributed to other family members. In addition, a taxpayer could claim that other factors such as the equipment used, other staff members, and trading goodwill all contribute to the profits of the business. By pointing to these factors, a taxpayer could contend that their efforts do not substantially generate the income of that business, in order to avoid the application of this rule.

This demonstrates that enacting a specific anti-avoidance provision to counter *Penny and Hooper* would not necessarily generate more certainty in this area. In fact, it may exacerbate this problem by providing taxpayers with further scope to manipulate the newly enacted rule. Uncertainty would remain, as it would be questionable whether the GAAR would apply to

²⁹⁹ At [35].

³⁰⁰ For example, see the grandchild and nephew example given in Section 3(c) – Identification of the benefit.

arrangements falling outside the scope of the new rule. In addition, this rule would operate as a blunt instrument which would not be appropriate to all taxpayers' circumstances. This is because some taxpayers would have a legitimate need to pay less than 80% of company profits as salary when it is needed for other purposes, such as paying back debt.

The extent to which uncertainty remains in the application of the "parliamentary contemplation" test in *Penny and Hooper*, can be justified by reference to the uncertain nature of tax avoidance, the need for the GAAR to retain a degree of flexibility and, the infeasibility of providing all-encompassing rules which can apply to the wide range of circumstances in which company/trust structures are employed. While the decision in *Penny and Hooper* does not contain a complete guide on tax avoidance in this area, the analysis provided in this chapter demonstrates the level of guidance is reasonable and any uncertainty in the Supreme Court's reasoning will only be at the margins of the "parliamentary contemplation test".³⁰¹ This displays how justifications for the level of certainty provided by the "parliamentary contemplation" test in Chapter Two, can be applied practically in this context to demonstrate how a sufficient level of certainty has been reached.

³⁰¹ *Ben Nevis*, above n 2, at [112].

CONCLUSION

A lot of the difficulty in the area of tax avoidance stems from the uncertain nature of tax avoidance and the wording of the GAAR. The definition of tax avoidance has been left deliberately general,³⁰² and a literal application of s BG 1 would counter many ordinary transactions which have the effect of “altering the incidence of tax”.³⁰³ While not every arrangement which has this effect will fall under the GAAR, the difficulty is determining which ones will constitute tax avoidance. The legislation has not spelt this out, so it has been left to the courts to determine this. The most recent effort by a higher court was the Supreme Court’s decision in *Ben Nevis* which outlined the “parliamentary contemplation” test. This approach represented a departure from Richardson J’s “scheme and purpose” approach in *Challenge Corporation*,³⁰⁴ as it promoted a greater focus on wider considerations rather than the nature of the specific statutory provision in issue.

A degree of certainty in the operation of the GAAR is needed to ensure that taxpayers are able to determine how a particular transaction will be treated by the law. Widespread uncertainty exposes taxpayers to a greater risk that their arrangements may fall foul of the GAAR, increasing administrative costs spent to ensure compliance with the law. This has to be balanced against the need for the GAAR to operate in a flexible manner to enable it to effectively counter tax avoidance. The “parliamentary contemplation” test does contain some uncertainty in that it may be difficult to determine whether a particular arrangement is inside Parliament’s contemplation. This raises the risk for an impressionistic analysis, based on the individual Judge’s views of the merits of the case. This concern can be reduced if the judiciary heeds the Supreme Court’s warning not to be influenced by subjective impressions of the morality of a particular arrangement.³⁰⁵

Certainty cannot be the overall objective as the law of tax avoidance is inherently uncertain. The uncertainty in this concept flows from the uncertain nature of income tax law itself, and this problem is exacerbated by taxpayers’ eagerness to find loopholes in the law. Parliament reacts to this by enacting new provisions to counter tax avoidance. This can create difficulty in situations where the new specific provision does not cover the particular

³⁰² *Ben Nevis*, above n 2, at [112].

³⁰³ Income Tax Act 2007, s YA 1: Definition of “tax avoidance”.

³⁰⁴ Above n 6

³⁰⁵ *Ben Nevis*, above n 2, at [102].

structure/arrangement, and raises questions as to whether the GAAR applies despite the existence of these specific rules.

The end result of this “game” played between taxpayers and Parliament is greater difficulty in determining whether an arrangement has the purpose of tax avoidance, no matter what test is applied to decide this issue. It has been demonstrated that the “scheme and purpose” approach does not bring any greater clarity to this issue. In addition, the “parliamentary contemplation” test represents an improvement in that it gives equal weighting to the GAAR and specific provision,³⁰⁶ and is derived from the wording of the GAAR. Such game playing by taxpayers cannot be condoned by the legislature, and thus the GAAR must operate with a degree of uncertainty to ensure that it can effectively combat tax avoidance, and provide a deterrent effect against aggressive tax planning.

Nonetheless, the level of certainty in the “parliamentary contemplation” test will only be justifiable if it is sufficient to provide taxpayers with a reasonable level of guidance. This test does provide some indicators of what constitutes tax avoidance. While these indicators are somewhat broad, they provide as much guidance as can be given to the wide range of factual circumstances in which tax avoidance may be present. In many instances, taxpayers can gain more specific guidance on the particular tax treatment of an arrangement by reference to the legislation, the case law and Inland Revenue guidance, in addition to the ability to get a binding ruling.

Parliament should be strongly encouraged to legislate on particular issues when it becomes aware of them. However, Parliament cannot be expected to predict every instance of tax avoidance and enact rules which provide complete coverage in a particular area. There will continue to be gaps in the legislation and loopholes to exploit. A legislative response on its own is insufficient to combat tax avoidance. Thus, there is a need for the GAAR to operate with some flexibility when Parliament fails to make its intention clear.

Penny and Hooper provides an example of the courts working to provide an answer in a difficult case. It is accepted that in marginal cases like this, it may be hard to determine the result in advance. Now that the Supreme Court has made its decision, taxpayers have more guidance on tax avoidance in relation to company/trust structures. The key elements of the Supreme Court’s reasoning that the arrangement was outside Parliament’s contemplation

³⁰⁶ At [103].

were three-fold. The absence of a commercially realistic salary being paid, coupled with a lack of justification for this level of salary, and the fact that the taxpayers retained the benefit of the use of funds received by the trust, led to a finding of tax avoidance. While it is acknowledged that further elaboration would have been beneficial to taxpayers' understanding of these factors, the third chapter of this dissertation has demonstrated that some guidance can be obtained in relation to these factors. A sufficient level of certainty is provided, as the lack of clarity in the "parliamentary contemplation" test in this area is largely limited to the margins in this area.³⁰⁷

As tax avoidance involves a degree of factual enquiry, cases will continue to reach the courts on whether an arrangement is inside Parliament's contemplation. This is no different to other areas of the law containing vague standards, which are determined by reference to some external benchmark. The difference is that with tax avoidance, some individuals will operate close to the boundaries of the law. This ensures that there will continue to be disputes in this area. The extent to which the application of the "parliamentary contemplation test" to the issue of tax avoidance results in a more uncertain approach than other areas of law, is justifiable given the difficulties in providing complete guidance in this inherently uncertain area of law and the need to effectively counter some taxpayers' willingness to exploit loopholes in the law.

This dissertation is of the view that the "parliamentary contemplation" test does provide a justifiable level of certainty in this area of law. The Supreme Court has correctly recognised that complete certainty is neither achievable nor desirable in this area of law, while at the same time, taxpayers are not left in the dark as to what constitutes tax avoidance. A degree of ambiguity in the "parliamentary contemplation" test warrants a more circumspect approach from taxpayers, as the pendulum has swung in favour of Inland Revenue with the Supreme Court taking a stricter line in interpreting the GAAR.³⁰⁸ The attitude of "paying what you have to and not a penny more" is still applicable in many instances where it is clear that Parliament has contemplated the particular tax advantage gained. However, in light of the decisions in *Ben Nevis* and *Penny and Hooper*, taxpayers should tread more carefully in situations which sit close to the boundaries of tax avoidance.

³⁰⁷ *Ben Nevis*, above n 2, at [112].

³⁰⁸ *Dunbar*, above n 79, at 417; *Littlewood*, above n 25, at 54, 65.

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APPENDIX

1. Key Sections of the Income Tax Act 2007

BG 1 Tax avoidance

Avoidance arrangement void

- (1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.

Reconstruction

- (2) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.

YA 1 Definitions

arrangement means an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect

tax avoidance includes—

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

tax avoidance arrangement means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—

- (a) has tax avoidance as its purpose or effect; or
- (b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental