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New Zealand’s General Anti-Avoidance Provisions: A Domestic Transfer Pricing Regime by Proxy?

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This article examines the similarities between the New Zealand courts’ analysis in recent tax avoidance cases and the international transfer pricing regime. We argue that the application of the parliamentary contemplation test provided by the Supreme Court shares many of the same features as the transfer pricing regime. In particular, the combination of economic analysis and market pricing referred to in recent cases suggests that the general anti-avoidance rules have, in effect, imposed on taxpayers a type of domestic transfer pricing regime. This requirement to demonstrate the commerciality of arrangements and provide evidence of market-based arrangements and pricing will inevitably create new uncertainties for New Zealand taxpayers.

1.0 INTRODUCTION

The recent New Zealand tax avoidance decisions have both raised the spectre of the general anti-avoidance rules (GAAR) being used as a surrogate domestic transfer pricing regime and generated arguments that the Income Tax Act provides for no such approach. While there are some specific provisions requiring taxpayers dealing with related parties to charge market value for certain goods or services in domestic transactions, there is no general requirement to pay market value in most circumstances. The omission of an explicit market-value requirement for domestic arrangements is possibly an acknowledgement that the value of goods or services is difficult to determine and that taxpayers themselves are best placed to agree on a price. Or the omission could reflect a policy view that there is no serious threat to the New Zealand tax base from domestic transfer pricing arrangements, although recent tax avoidance cases clearly demonstrate that this is not so. In any case, this apparent freedom over the pricing of domestic transfer pricing arrangements is increasingly illusory. Using the GAAR, the Commissioner has repeatedly intervened to reset or reallocate the price paid for the goods or services for tax purposes in what amounted to domestic transfer pricing arrangements.

[(2011) Vol 17:4 NZJTLP 419, 420]

Recent tax avoidance cases have examined the economic substance of disputed arrangements to verify their commerciality rather than undertake a careful consideration of the form of the transactions. In every recent case, the court has identified one (or more) uncommercial or artificial aspect of the taxpayers’ behaviour. These cases have involved arrangements with significant non-market aspects or the existence of non-arm’s length pricing. In each instance, that non-market aspect of the transaction fatally undermined the taxpayer’s case.

The approach by the courts in those cases forced taxpayers to defend either the price agreed for the goods or services or how that price was paid, with the onus of proof falling squarely on the taxpayer. This has resulted in the GAAR being used as a type of domestic transfer pricing mechanism by which the Commissioner freely examines the underlying economics of the taxpayers’ conduct and, where uncommercial behaviour is found, the Commissioner uses his reconstructive powers to substitute his own view of the proper market value or the true amount paid.

If the GAAR is being used to impose a quasi-domestic transfer pricing regime, then what are the implications for New Zealand taxpayers? In particular, what transactions can taxpayers legitimately enter into with related parties? What pricing should they adopt to ensure that their arrangements do not fall within the scope of the GAAR? And what steps should taxpayers take to protect themselves against the application of the GAAR in this way?

This article reviews recent tax avoidance cases and identifies the factors relied upon by the courts using the “parliamentary...
contemplation” test expounded by the Supreme Court in Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue. It concludes that the under- or over-payment for goods or services often constitutes the “uncommerciality” or “contrivance” that triggers the operation of the GAAR. As such, the Ben Nevis decision marks a “sea change” to the law of tax avoidance in New Zealand that is only now being fully recognised. Specifically, the article reviews New Zealand’s transfer pricing regime in section 2, followed by a discussion of the arm’s length principle in section 3. Section 4 then considers the Supreme Court’s parliamentary contemplation test, and section 5 discusses the economic analysis of the arrangements. The article then considers the application of the parliamentary contemplation test in subsequent cases in section 6 and transactions involving related but not associated persons in section 7. We compare the approach taken in these recent cases with the scope and application of the arm’s length principle contained in the international transfer pricing rules. The article concludes in section 8 that the international transfer pricing rules can provide guidance to taxpayers on how to substantiate the commerciality of their arrangements and, thus, avoid the application of the GAAR.

2.0 NEW ZEALAND’S TRANSFER PRICING REGIME

New Zealand’s transfer pricing regime took effect from the 1996-97 income year and closely follows the provisions of Article 9 of the OECD Model Tax Convention. Under these rules, the pricing of cross-border arrangements between associated persons is required to be in accordance with the arm’s length principle. This principle requires the price paid in a controlled transaction (that is, one between two related parties) to be equal to the price that a willing and informed buyer and a willing and informed seller would agree on in an open market after fully-adequate bargaining.

The transfer pricing rules are a specific anti-avoidance regime designed to protect the New Zealand tax base from the movement of pre-tax profit from domestic taxpayers to overseas related parties, thereby avoiding the imposition of New Zealand tax. The issue of international transfer pricing is regarded as one of the most significant for multinational enterprises (MNEs). However, many overseas jurisdictions have recognised that the transfer pricing problem not just is an international issue, but also affects domestic transactions. For example, the United States and the United Kingdom transfer pricing regimes apply to both domestic and international arrangements. This recognises that the tax base is also at risk from domestic transactions between related taxpayers who have different marginal tax rates (particularly transactions between taxpaying and exempt entities) or different tax profiles (such as where one has accrued losses).

The omission of a domestic transfer pricing regime in New Zealand may reflect a view that there is no significant danger to the tax base where both parties to an arrangement are New Zealand taxpayers. In 1995, when the transfer pricing legislation was introduced, the top marginal tax rate for individual taxpayers was 33 per cent, equal to the prevailing company and trust tax rates and only nine per cent above the lowest marginal rate. As a consequence, there were limited opportunities for taxpayers to transfer income to reduce the applicable tax rate. However, from the 2000-01 income year the top marginal tax rate for individuals increased to 39 per cent for income over $60,000. This increased the incentives for taxpayers earning higher incomes to restructure their affairs. It is only recently that the top marginal tax rate has again reduced, possibly reflecting not only the political philosophy of the current government but also a recognition of the perverse incentives that arise for taxpayers faced with a disparity between the tax rates for individuals and those for other entities. It is not a coincidence that a large number of recent tax avoidance cases have involved individual taxpayers restructuring their affairs to shift personal services income into companies and/or trusts.

3.0 THE ARM’S LENGTH PRINCIPLE

The New Zealand transfer pricing regime is based on the arm’s length principle contained in Article 9 of the OECD Model Tax Convention. This principle requires that where related parties transact cross-border and:

“… in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

Article 9 does not provide any methodology by which profits should be calculated and the Commentary provides the following assistance:

“The Committee has spent considerable time and effort (and continues to do so) examining the conditions for the application
of this Article, its consequences and the various methodologies which may be applied to adjust profits where transactions have been entered into on other than arm’s length terms. Its conclusions are set out in the report entitled Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which is periodically updated to reflect the progress of the work of the Committee in this area. That report represents internationally agreed principles and provides guidelines for the application of the arm’s length principle of which the Article is the authoritative statement.”

The OECD Transfer Pricing Guidelines provide five methods for demonstrating that the prices paid are in accordance with the arm’s length principle. These methods require that the price or profits arising from a related party arrangement (or “controlled” transaction) be compared to the price or profits arising in an arrangement between unrelated parties (or “uncontrolled” transaction). These methods are contained in s GC 13(2) of the Income Tax Act 2007.

Three of the methods, the comparable uncontrolled price, the resale price and the cost plus methods, are transactional methods that calculate the transfer price with reference to the price paid or the gross profit earned in similar transactions between unrelated parties. The other two methods, the profit split and the comparable profits methods, calculate transfer prices with reference to the arm’s length net profit that should be earned for the functions, risks and assets contributed by the related parties to the controlled transaction or group of transactions.

Inland Revenue’s transfer pricing guidelines set out a four-step process that Inland Revenue recommends taxpayers apply to support the arm’s length nature of their transfer prices. The documentation prepared as part of this process will provide taxpayers with evidence that they have selected and applied the method that provides “the most reliable measure of the amount that completely [(2011) Vol 17:4 NZJTLP 419, 423] independent parties would have agreed upon after real and fully adequate bargaining”. In addition, this process should assist taxpayers to both lower their risk of a transfer pricing adjustment and demonstrate that they have taken reasonable care in applying the transfer pricing rules. However, the approach is not mandatory and for small taxpayers or low-value transactions, the cost of applying this process may be prohibitive.

The first step comprises a review of the cross-border dealings between the related parties to enable the Commissioner to understand those dealings in the context of the business, that is, the commercial nature of the transaction(s). This step involves describing the economic and market context of the arrangement and identifying comparable data from uncontrolled transactions that could be used to apply one or more of the transfer pricing methods. An important part of this step is the preparation of a “functional analysis”, which provides a description of the functions performed, assets used and risks assumed by each party to the arrangement. This functional analysis is an essential part of any transfer pricing analysis as it outlines the relative contributions of each party. Under arm’s length dealings, the profits of each party are expected to reflect these relative contributions.

The second step comprises the selection of the most reliable transfer pricing method or methods to apply to the arrangement. The most reliable method will reflect the nature of the transaction, the business activities of the taxpayer, and the reliability of the available comparable data. In this respect, the Income Tax Act 2007 requires the taxpayer to choose the method with reference to:

(a) The degree of comparability between the uncontrolled transactions used for comparison and the controlled transactions of the taxpayer;

(b) The completeness and accuracy of the data relied on;

(c) The reliability of all assumptions;

(d) The sensitivity of a result to possible deficiencies in the data and assumptions.

The third step involves the application of the transfer pricing method identified as the most reliable in the second step. The functional analysis is used to determine the comparability of controlled and uncontrolled transactions, with reference to the taxpayer’s business strategy. This analysis requires the identification of data from multiple years and the determination of any adjustments required to reflect differences in the controlled and uncontrolled transactions (for example, differences in payment terms). In most cases, the application of a method will require the taxpayer to identify a point within a range of arm’s length results that supports their transfer prices. For high-value transactions, it may also be necessary for the taxpayer to consider the application of a secondary method to support the results of the primary method.

In the last step, the taxpayer is required to calculate the arm’s length amount using the method and comparable data identified in the previous steps. Given the potential limitations inherent in applying the arm’s length principle, particularly in relation to the identification of robust comparable data, all analyses will inevitably require the application of judgment by the taxpayer to determine an appropriate arm’s length amount. Ideally, the analysis should detail any significant assumptions and the reasoning for any subjective judgments made.
The transfer pricing regime and this four-step process require taxpayers to consider the commercial nature of their dealings. In effect, related taxpayers are obliged to demonstrate that the price they have adopted conforms to one or more of the prescribed methods. This is a non-trivial task that requires significant documentation and rigorous economic analysis. Inland Revenue acknowledges that this transfer pricing obligation requires taxpayers to prepare more analysis than they would for normal business dealings. However, Inland Revenue’s view is that without this additional analysis it would be “sacrificing the integrity of New Zealand’s transfer pricing rules”. Further, where a taxpayer fails to perform this type of analysis, either because they select a method that does not use the best available data or because they fail to apply any method, then the Commissioner can determine the appropriate transfer price for the arrangement.

The Commissioner’s concern is whether sufficient profits have been returned in New Zealand. Inland Revenue’s 2011 compliance focus identifies transfer pricing as one of its key areas for audit activity. As a consequence, Inland Revenue’s transfer pricing audits concentrate on identifying taxpayers who have a high level of transfer pricing risk. This risk is a function of various factors. Notably, risk is determined by the level of documentation prepared, the materiality of the transactions that have not been benchmarked, whether the New Zealand taxpayer’s profits have significantly declined, particularly following a restructure or change in ownership, or whether those profits are significantly less than comparable New Zealand industry levels.

If the GAAR is providing a surrogate domestic transfer pricing regime, then the international requirements suggest that taxpayers engaged in tax-advantageous domestic arrangements will need to perform additional economic analyses to reduce their level of risk. This would include comparing prices or profits to external benchmarks and preparing related documentation to support the prices paid in domestic transactions. In the next section, we review the recent decisions applying the GAAR and consider the extent to which the tests set out by the courts in those cases have gone down this path.

### 4.0 GENERAL ANTI-AVOIDANCE: THE SUPREME COURT PARLIAMENTARY CONTEMPLATION TEST

The starting point for considering the impact of the GAAR on domestic transfer pricing is the Trinity and Glenharrow cases. Although they involved very different factual scenarios under different Acts, they represent the Supreme Court’s first consideration of tax avoidance. The Glenharrow judgment repeatedly refers to the reasoning in the Trinity decision to support its conclusions. As such, the decisions obviously contain a number of consistent principles and clear sign-posts regarding the treatment of tax avoidance. ([2011] Vol 17:4 NZJTLP 419, 425]

The facts and decision in the Trinity tax avoidance arrangement are now well-known. The Supreme Court found that an immediate deduction for the future payment of a license fee of $2 million per hectare to use forestry land, and an insurance premium over the future value of the trees, constituted tax avoidance, in breach of the GAAR. The license fee and insurance premium were both inflated and not actually payable for 50 years and, therefore, the taxpayers were not entitled to claim an immediate deduction for those expenses, even though all the requirements for deductibility under the black-letter provisions had been met. Significantly, the taxpayers were not strictly “associated” to the counterparties under the arrangement (the Trinity charity and the captive insurer), but it was apparent that the entire arrangement and all pricing had been determined by the promoter at the outset and was never the subject of negotiations.

The Supreme Court in Ben Nevis confirmed that the GAAR can apply despite absolute compliance with the applicable specific provisions under which the tax benefit is obtained. It stated:

> “Thus, tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps in an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement.”

But the Supreme Court gave more muscle to the application of the GAAR by expressly finding that it must be read alongside all other provisions in the Act, rather than only as a “longstop”, as suggested in earlier cases. The Court noted that it must balance the legislative policies behind both the particular regimes relied upon by taxpayers and the general anti-avoidance provision. The Court acknowledged an inconsistency among previous authorities and, therefore, took the opportunity to lay down the law on tax avoidance in New Zealand:

> “There is therefore continuing uncertainty about the inter-relationship of the general anti-avoidance provision with specific provisions. That makes it desirable for this Court to settle the approach which should be applied in New Zealand.”
As becomes apparent in the majority judgment, the focus of the Supreme Court’s new approach is on the factual background of how the specific provisions are used. In particular, when applying the general anti-avoidance provision, the majority set out a two-step test: [(2011) Vol 17:4 NZJTLP 419, 426]

- The first step is whether the taxpayer has used the specific provisions within their intended scope. This is determined primarily by the specific provision’s ordinary meaning, as established through their text and in light of their specific purpose.

- The second step considers the use of the specific provisions in light of the arrangement as a whole. It is at this stage that s BG 1 applies in tandem with the specific provisions.

The Court summarised this test as examining:

“the taxpayer’s use of the specific provision viewed in the light of the arrangement as a whole. If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of tax, in a way which cannot have been within the purpose or contemplation of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement.”

Helpfully, the Supreme Court sets out the factors relevant to determining whether an arrangement falls outside the contemplation of Parliament. Those factors include:

- The manner in which the arrangement is carried out.

- The role of all relevant parties and the relationship they have with the taxpayer.

- The economic and commercial effect of the documents and transactions.

- The duration of the arrangement.

- The nature and extent of the commercial consequences of the arrangement.

- The market value of all supplies of goods or services as part of the arrangement.

Applying those factors, the majority explained that the “ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provisions in a manner that is consistent with Parliament’s purpose”. This “ultimate question” establishes the so-called “parliamentary contemplation test”.

On its face, this new test reduces tax avoidance down to a question of fact and degree by comparing the tax purpose of an arrangement with any other (usually commercial or family) purposes. The enquiry virtually presumes that tax-driven transactions tend to be artificial and contrived as they are not focused on commercial realities. Therefore, if the specific provisions are used as part of an arrangement that has little commercial rationale, then Parliament is unlikely to have contemplated such use. Based on that reasoning, the majority concluded that:

“[i]t will rarely be the case that the use of a specific provision in the manner which is outside Parliamentary contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental.”

The Supreme Court’s enquiry in Ben Nevis was primarily factual. It determined that Parliament would not contemplate tax benefits
being obtained through artificial arrangements. The Court expressly [(2011) Vol 17:4 NZJTLP 419, 427] reserved for itself a wide power to consider any and all potentially relevant factors. It is not restricted to simply reviewing the legal form of the arrangement, either its individual steps or as a whole, but instead it may examine the economic substance of an arrangement to determine whether the claimed tax benefit was obtained in a contrived or artificial manner:

“In considering these matters, the courts are not limited to purely legal considerations. They should also consider the use made of the specific provision in the light of the commercial reality and the economic effect of that use.”

The Court therefore focused its attention on the commerciality, contrivance and artificiality of the arrangement. The conclusion drawn by the Supreme Court was that Parliament did not intend to bestow tax benefits if the tax benefits were obtained in a contrived and artificial manner, virtually regardless of the scheme and purpose of the applicable black-letter provisions. As the majority concluded:

“It will often be the combination of various elements in the arrangement which is significant. A classic indicator of a use that is outside Parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament’s purpose for specific provisions to be used in that manner.”

At its simplest, tax avoidance can thereby be reduced to an examination of the commerciality of an arrangement, with any non-market aspects likely to breach s BG 1. This view is reinforced by the wording of the conclusion reached by the Supreme Court that:

“In each case the expenditure satisfied the ordinary meaning of the specific provisions relied on to claim the deductions. The appellants were, however, also required by the general anti-avoidance provision to show that the specific provisions they relied on had been used in a manner which was within Parliament’s purpose and contemplation when it enacted them. Having regard to the various features of the arrangement we have discussed, our conclusion is that the appellants’ use of the specific provisions was not within Parliament’s purpose and contemplation when it authorised deductions of the kinds in question.”

The simultaneous Supreme Court decision in Glenharrow Holdings Ltd v Commissioner of Inland Revenue relied on similar reasoning in the GST context. The facts in that case are also well-known, involving the sale between two non-associated taxpayers of second-hand goods, namely, a mining license (previously purchased for $10,000) for $45 million. That price was payable by instalments out of profits from working the mining license but the purchaser immediately claimed a GST input tax credit for the full amount, being $9 million.

The Supreme Court in Glenharrow warned against “transactions that have artificial features combined with advantageous tax consequences not contemplated by the scheme and purpose of the [(2011) Vol 17:4 NZJTLP 419, 428] Act”. After examining the facts of the arrangement, the Supreme Court found that the deferred and incomplete payment was artificial. Therefore, regardless of their honest motives, the taxpayers had acted uncommercially to obtain a tax benefit and their arrangement constituted tax avoidance.

5.0 ECONOMIC ANALYSIS OF THE ARRANGEMENTS

The most notable aspect of the Supreme Court’s approach is its reliance on economic analysis to determine whether an arrangement falls outside the contemplation of Parliament. There are striking similarities between the analysis proposed by the Supreme Court and the functional analysis necessary under New Zealand’s transfer pricing regime. Inland Revenue’s transfer pricing guidelines describe a functional analysis as a “method of finding and organising facts about a business in terms of its functions, assets (including intangible property), and risks”. This analysis considers the nature of the business dealings, the context in which they occur, the economically significant activities that are performed by each party, and their relative value. Consideration is also given to the relevant economic and market conditions, contractual terms, risk allocations, the impact of business strategies, government policies, or any other external factors (for example, the geographic location of the transaction) that are likely to affect the arm’s length price.
While the scope of a functional analysis required for international transfer pricing arrangements may be wider than the areas discussed by the Supreme Court, in essence, the same question is being addressed: “what is the economic nature of the arrangement?” The Supreme Court considered this question in light of whether an arrangement is commercial; the transfer pricing rules consider it in light of determining an arm’s length price. However, both approaches are focused upon ensuring that taxpayers do not artificially reduce their income tax burdens by dealing with other parties at non-market prices.

While neither of the arrangements considered by the Supreme Court was between associated parties, aspects of the two cases suggest that the parties had been acting in concert. This is not uncommon in tax avoidance arrangements, in which non-associated parties may collude or, at least, acquiesce in the design of non-market arrangements that generate the desired tax advantages for both. Similar to the application of the GAAR, the international transfer pricing rules can apply to arrangements between non-associated parties, through the operation of s GB 2 of the Income Tax Act 2007. This section provides an additional layer of anti-avoidance to the transfer pricing regime and applies to arrangements that have the purpose or effect of defeating the application of the transfer pricing rules, for example, collateral arrangements such as market-sharing or income-sharing arrangements. Accordingly, an arrangement between non-associated parties designed to inflate or deflate prices to provide a mutual benefit to the parties, while reducing the New Zealand tax base, may be caught by this provision. For this reason, Inland Revenue considers that the transfer pricing regime applies to “related” parties, and therefore uses this term throughout its transfer pricing guidelines, and not only to “associated persons” within the categories identified in subpart YB of the Income Tax Act 2007.

The Supreme Court in both the Ben Nevis and the Glenharrow decisions emphasised that taxpayers must bear the true economic cost of any tax benefit they claim. The starting point of this economic analysis was the Privy Council’s decision in Challenge Corp Ltd v Commissioner of Inland Revenue. There, Lord Templeman found:

“In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the costs of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax.”

The Supreme Court concluded that the underlying reasoning of both the Challenge and the Peterson decisions was whether the commercial reality of the respective transactions was consistent with their legal form:

“[T]he courts are not limited to purely legal considerations. They should also consider the use made of specific provisions in the light of the commercial reality and the economic effect of that use. The ultimate question is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific provision in a manner that is consistent with Parliament’s purpose.”

In Ben Nevis, the Court considered that the use of promissory notes payable in fifty years meant that neither the licence fee nor the insurance premium had really been paid by the taxpayers, on the basis that, while technically correct in law that the premium had been paid, in substance, the debt remains unpaid. The purported payment therefore did not give rise to any economic consequences on either side. This meant that the investors in the scheme could achieve substantial tax advantages by deduction of the second premium without suffering any corresponding economic outlay. The majority observed:

“... under the arrangement the appellants will receive the benefits of tax deductions but probably never incur the real expenditure. ... [T]he Court is permitted, when considering the question of tax avoidance, to examine the commercial nature of the incurred cost and any factors that might indicate that the expenditure will never be truly incurred.”

The issue of whether “payment” was economically made was also a key issue in Glenharrow with respect to the use of vendor finance. The Supreme Court stated: [(2011) Vol 17:4 NZJTPL 419, 430]

“[T]he arrangement still had a very artificial element: the price was not paid in economic terms, even though as between the parties a debt was discharged. In this case it is not the price but the ‘payment’ that created the distorting effect.”
In Glenharrow, the Court concluded that the use of vendor finance (to a $100 shelf company with no guarantee from its owners and no realistic possibility of repaying the loan from exploiting the mining licence) did not actually amount to payment for the mining licence. In reality, the only part of the $45 million purchase price that was truly paid was the $80,000 deposit and a subsequent payment of $210,000. The Court concluded that the vendor finance:

"… [produced] an artificial effect with consequent tax advantage, contrary to all economic reality. … The terms of the arrangement … had no such reality as a ‘cash’ transaction, despite being structured as if it were."

Surprisingly, neither Ben Nevis nor Glenharrow identified the inflated price as constituting tax avoidance; rather, the lack of actual payment of that amount was decisive. Accordingly, these cases do not necessarily overturn the long-standing rule in Cecil Bros Pty Ltd v Federal Commissioner of Taxation and Europa Oil (NZ) Ltd v Commissioner of Inland Revenue that it is not for the Commissioner or the court to tell a taxpayer how much to spend in obtaining its income. Those cases remain good law. Rather, the economic consequences test appears to focus upon whether the taxpayer has actually paid or will realistically pay the agreed price. The taxpayer must have truly suffered the economic cost of the tax benefit it has claimed: Anything less may not be sufficient.

This contrasts with the approach under the transfer pricing rules, where consideration of whether the price is arm’s length is the primary test for determining whether the rules apply. However, this difference may reflect the different purposes of the two regimes. The GAAR determines whether an arrangement in its totality constitutes tax avoidance; whereas the transfer pricing rules determine whether the transfer price gives rise to tax avoidance. In this respect, the OECD Transfer Pricing Guidelines specifically state that only in exceptional circumstances should a tax administration disregard the actual transactions. However, while Ben Nevis or Glenharrow did not consider that the inflated prices alone constituted tax avoidance, had those prices reflected arm’s length amounts or those arrangements incorporated more realistic payment terms, then it is unlikely that either case would have constituted tax avoidance under the GAAR.

[(2011) Vol 17:4 NZJTLP 419, 431]

6.0 APPLICATION OF THE PARLIAMENTARY CONTEMPLATION TEST IN SUBSEQUENT CASES

6.1 Introduction

The reasoning in Ben Nevis has been applied in all subsequent cases. As stated by the Supreme Court, that decision was intended to resolve any uncertainty in previous case law and dictate the approach to tax avoidance for future cases. Accordingly, all subsequent cases have applied the new approach mandated in that decision, and largely ignored the approach of prior cases. As noted by Harrison J in Westpac:

"I agree with Wild J in the BNZ Investments (No 2) case at [114] that the Supreme Court’s decisions in Ben Nevis and Glenharrow should render a review of the pre-existing case law otiose."

That approach has been questioned by some commentators, who continue to argue for the more technical approach adopted in prior cases by both the Court of Appeal and the Privy Council. For instance, one commentator described the Supreme Court judgment in Ben Nevis as "unfortunately having … effectively bypassed an analysis of the correct statutory elements needed to determine whether a tax avoidance arrangement existed and instead substituted its own [parliamentary contemplation test]." That commentator concluded:

"It is hoped however the misstatements of the law seen in Ben Nevis will be corrected by the Supreme Court [when it considers the taxpayer’s appeal in Penny & Hooper]."

Despite that view, the court in each subsequent case has applied the parliamentary contemplation test and undertaken a factual examination of the arrangement to identify elements of contrivance or artificiality. In each case, non-arm’s length pricing or failure by the taxpayers to truly suffer the true economic cost doomed the arrangement to a finding of tax avoidance.
6.2 Structured Finance

The structured finance litigation concerned the correct tax treatment of a number of “repo deals” entered into by New Zealand’s major trading banks. Under the deals, a subsidiary of the bank would purchase an equity interest in a special purposes issuer that was the subsidiary of a substantial foreign counterparty. In economic substance, the bank was providing loan funding to the counterparty but the bank’s return was in the form of an equity distribution from the foreign issuer, which was calculated according to three separate factors:

- The interest rate swap entered into between the parties;
- The payment by the bank of a guarantee procurement fee of approximately 2.95 per cent; and
- The bank’s underlying borrowing costs.

The bank would deduct its cost of borrowing, the guarantee fee and the net cost of the interest rate swap while treating the distributions from the issuer as either exempt from tax under the “conduit” tax relief rules, or relieved from tax under the foreign tax credit rules.

The result was the taxpayers claimed a deduction for all expenses but returned nil income, thereby generating substantial tax losses on the transactions that were offset against other sources of income. The Commissioner alleged that these transactions were devoid of commercial purpose other than the exploitation of tax asymmetry and simply provided a mechanism for the tax benefits to be divided between the bank and the foreign counterparties. In particular, the Commissioner alleged that the guarantee fee was entirely contrived, in that it was both artificial for the lender to pay for such security, and inflated.

When the substantive challenges by two of the banks were finally heard, the High Court ruled in favour of the Commissioner in both cases. Significantly, both Wild J (in BNZ) and Harrison J (in Westpac) considered that Ben Nevis marked a radical change in the approach to tax avoidance. Harrison J concluded that the Supreme Court decision had endorsed the reasoning and “economic reality approach” of Woodhouse P in Challenge and constituted “a ‘diplomatic rejection’ of Richardson’s J’s approach to tax avoidance.”

As a result, both judgments focused upon the commerciality of various aspects of the arrangement and paid comparatively little attention to the scheme and purpose of the regimes relied upon by the banks. In particular, the importance of the guarantee fee to the tax avoidance analysis was recognised by Harrison J:

“Of necessity, the question of whether the transactions were tax avoidance arrangements is amorphous. The Commissioner points to a number of features which individually or collectively, he says, are indicia of tax avoidance. As earlier noted, the part played by the GPF is at the heart of what must be a wide-ranging inquiry; the findings on its permissibility will inevitably affect all other questions.”

On this point, his Honour suggested that the structure of the arrangement itself may not have constituted tax avoidance, but for the use of the uncommercial guarantee fee:

“The real issue at the heart of the tax avoidance inquiry is whether it was permissible for the bank to have paid and claimed a deduction for the GPFs.”

In fact, Harrison J considered that the allegation of tax avoidance may not even have been made if the Commissioner had not suspected that the guarantee fee was so artificial. [(2011) Vol 17:4 NZJTL 419, 433]
“The existence of the GPF is central to the Commissioner’s allegation of tax avoidance. ... The Commissioner’s specific challenge relates to the GPF’s legitimacy: but for the GPF, it is unlikely he would have questioned these transactions.”

Harrison J reached this view despite acknowledging “a significant disjunct between the economic substance of the Koch transaction as a loan and its legal form as an equity investment.”

In effect, the structured finance litigation came down to an examination of the commerciality of the 2.95 per cent guarantee fee and, to a lesser extent, the cash-negative result from each arrangement. On this analysis, Wild J found that “the transactions generated the claimed deductible expenses in a contrived or artificial way”. Likewise, Harrison J concluded:

“I am in no doubt that the GPF’s function was to generate a statutory deduction for an expense which appeared genuine but was in truth a contrivance ... Its existence is a ‘classic indicator’ of a tax avoidance purpose ... Westpac claimed a deduction for the GPF on the misleading representation, which it must have expected the Commissioner to accept in good faith, that the expense was commercially justifiable and fixed at a market rate.”

Harrison J summarised the effect of the guarantee fee on the reasoning in both cases by noting that “I appreciate that I have reached the same conclusion on avoidance as Wild J in BNZ Investments (No 2). The interposition of the GPF has proved decisive on the facts of both cases.”

Likewise, both judgments concluded that the pre-tax negative effect of the arrangement was uncommercial. For instance, Harrison J concluded:

“The fact that conduit relief enabled a taxpayer to obtain dividends which accrued credits is not problematic in itself. It is the fact that the transactions were loss making, and thus never resulted in dividends being paid to non-resident shareholders, which is an objectionable consequence of the transaction as a whole. In my judgment it would not have been within Parliament’s intention to allow a taxpayer to structure a transaction in such a way that NRWT would never be paid.”

As mandated by Ben Nevis, both High Court decisions involved an analysis of the economic substance of the arrangement, while paying comparatively little attention to the regimes under which the tax benefits were claimed. The approach in these cases is therefore remarkably similar to that used by the courts when conducting a transfer pricing analysis. As noted by one commentator:

“While strictly speaking the New Zealand transfer pricing legislation was not actually applied in the BNZ case, the cornerstone principle of arm’s length dealings enhanced the Judge’s view that tax avoidance was present ... The finding begs the question that if the transactions had been set based on arm’s length principles, whilst still enjoying the structured finance benefits of the cross-border transactions, whether the Courts would have found tax avoidance. Instead, the lack of sustainable cross border pricing lead to a tainting of the entire transactions, and the determination of tax avoidance.”

[[2011] Vol 17:4 NZJTPLP 419, 434]

While many expected the approach adopted in these cases to be reconsidered through the appeals process, all challenges were settled on Christmas Eve 2009, presumably using the Commissioner’s care and management powers under s 6A of the Tax Administration Act 1994, as mandated by the Court of Appeal in Accent Management Ltd v Commissioner of Inland Revenue.

6.3 Education Administration Ltd

Education Administration Ltd v Commissioner of Inland Revenue involved a comparatively simple arrangement, whereby two co-venturers (who were personal friends and business partners but were not technically associated) agreed to establish different companies to develop and exploit educational software. Both companies registered for GST, with one returning GST on an invoice basis and the other on a payments basis. The payments-basis company invoiced the other company for work at $160 per hour. While the parties had agreed that only 10 per cent was actually to be paid, and therefore the payments-basis taxpayer returned only $16 per hour, the invoice-basis taxpayer claimed a GST input tax credit for the full amount. The Commissioner alleged that the
structural timing difference generated by the arrangement between the companies constituted tax avoidance in breach of s 76 of the Goods and Services Tax Act 1985.

Applying the reasoning of the Supreme Court in both Ben Nevis and Glenharrow, French J easily held that the arrangement lacked any commercial justification and, therefore, constituted tax avoidance. Her Honour found that both the hourly rate charged and the non-payment of 90 per cent of that fee was artificial:

"I am satisfied on the evidence that in the circumstances the rate agreed for this particular project was not a market rate … The effect of adopting an inflated hourly rate was of course to artificially increase the amount of the invoices and hence the amount of the GST refund that could be claimed."

On that basis, French J concluded that "I am satisfied that in combination they point to an arrangement that was artificial and contrived in the manner described by the Supreme Court in Ben Nevis." In this case, the Court considered whether the price was a market rate, in addition to considering whether the price was paid. That is, the non-market price was used as evidence of the artificiality of the arrangements and, ultimately, resulted in the failure of those arrangements. This contrasts with the Supreme Court decisions, which did not specifically address whether the agreed price was a market price, but is a logical extension of the economic analysis approach provided for in the parliamentary contemplation test.

6.4 Krukziener

This case involved interest-free loans to a property developer from his various companies and trusts. The developer undertook a series of developments and capital investments, using a different company or trust for each project. The developer had arranged his affairs so that any profit generated from the completion of one project was distributed or offset against losses incurred during the start-up phase of [(2011) Vol 17:4 NZJTLP 419, 435] other projects. After taking advantage of all of these offsets, there was little profit within the group and so almost no tax was payable over many years. Nevertheless, the Commissioner did not object to this use of the companies and trusts by the developer.

From 1990-2001, the developer paid himself only a minimal salary for his services on each project. He funded his rather lavish lifestyle with large drawings from his current accounts with those companies and trusts. While the balance fluctuated over time, from 1990 until 2001 the developer had overdrawn his current accounts by more than $3 million. Those funds were generally borrowed by the companies and trusts from external lenders at commercial interest rates but on-lent to the developer at nil interest.

The Commissioner alleged that the developer’s practice of living off large current account borrowings while receiving negligible income for his services to those companies and trusts constituted tax avoidance. In Case Z23, the Taxation Review Authority (TRA) ruled in favour of the Commissioner on the grounds that the loans from the trusts and companies were entirely artificial and were simply a substitute for salary or profit distributions that should have been paid to the developer.

The TRA’s decision was upheld by the High Court in Krukziener v Commissioner of Inland Revenue. The Court ruled that, while proprietors living on current account drawings may be both widespread and normal practice, in this instance the amount of the borrowing, the length of time for which the loans were outstanding and the lack of repayment meant that the developer’s arrangement constituted tax avoidance. Courtney J considered:

"It may be that the proprietor of a property development business would, for the reasons that Mr Krukziener gave in evidence, be justified in accepting a salary below market or even no salary at all pending the completion of the project. … However, there is an obvious question on the facts of this case as to why Mr Krukziener would not have received any income over such a long period."

While loans are not generally treated as income, in this case her Honour considered that Parliament would not have intended the developer to live almost entirely on borrowings instead of income. As the developer controlled all the trusts and companies in the group, he alone determined what would be borrowed, how it could be used, and when/if it would be repaid. Courtney J ruled:

"the Commissioner’s argument against the existence of a genuine commercial rationale was compelling. It was apparent that during the period that Mr Krukziener owed the … entities money under his current accounts, the group was funded by
external borrowings. These borrowings attracted interest at commercial rates. Notwithstanding the fact the group was meeting the cost of external borrowing at a time when Mr Krukiener owed it substantial money, there was no demand for repayment. Nor was interest required to be paid … Against these various disadvantages, the tax benefits of the arrangement stand out clearly."

Therefore, under the parliamentary contemplation test established by the Supreme Court in Ben Nevis, the developer’s arrangement constituted tax avoidance. As a result, all current account loans made to the developer by the companies and trusts were treated as distributions of income that were subject to tax. [(2011) Vol 17:4 NZJTPL 419, 436]

6.5 White

The White case concerned a comparatively simple arrangement involving the offsetting of income from professional services against losses from the taxpayer’s farming activity. The taxpayer was an anaesthetist who had previously traded profitably in her own name. She sold her anaesthetist practice to a company, owned by herself and her husband, which also owned and ran an avocado orchard. Due to unexpected losses from the avocado orchard, the company ran at a loss. Profits from the anaesthetist practice were offset against the orchard losses, resulting in nil profit to the company overall, so it was unable to pay the anaesthetist for her professional services. The result was that the anaesthetist earned substantial income from her personal services but, after offsetting against the orchard losses, paid no tax on that income.

The Commissioner alleged that the company’s failure to pay the anaesthetist for her professional services constituted tax avoidance as it contravened the principle that a taxpayer was liable to tax on their personal services income, and her diversion of that income into her loss-making company was uncommercial.

In Case Z24, the TRA found that the anaesthetist’s arrangement constituted tax avoidance. It ruled that she had derived considerable profit from the practice in her own name and the arrangement to transfer her practice into the company owning an avocado orchard was entirely artificial. Her decision to work as an anaesthetist without pay by the company lacked commercial reality.

On appeal, in White v Commissioner of Inland Revenue the High Court overturned the TRA’s decision. It ruled that there was nothing uncommercial about a taxpayer making a profit from one activity and a loss from another activity, and offsetting the two. As the proprietor of the company (conducting both the anaesthetist and the orchard business), the taxpayer could only be expected to pay herself from profits available – and was not obliged to pay herself if no profit was available. Heath J determined that:

- “the reason that no money was available for [the company] to pay a salary to Dr White was because income had to be diverted to pay real (not contrived) debts.”
- “this was not a case in which a reduced salary was deliberately paid. Rather, it was a case in which salary was not paid because the company lacked funds to do so.”

Many commentators have noted that there were many other ways in which the taxpayer could have achieved the same tax result, for example:

- By conducting the anaesthetist practice and the orchard business in her own name, or
- By conducting the anaesthetist practice in her own name and running the orchard business in a loss-attributing qualifying company (LAQC) (or now a look-through company (LTC)), which would have attributed the orchard loss to her to be offset against her anaesthetist practice, or

[(2011) Vol 17:4 NZJTPL 419, 437]

- By conducting the anaesthetist practice in one company and the orchard business in another, and electing under the Income Tax Act 2007 to offset the profit from the anaesthetist practice against the orchard loss.
Given that each of these alternative structures would have delivered the same tax result, it was difficult for Inland Revenue to maintain that this particular arrangement breached parliamentary contemplation. On this point, his Honour concluded:

“Dr White formed and used a closely held company to obtain a tax advantage in a manner that was not inconsistent with the purpose for which the use of such a company was allowed. In arranging her affairs in that way, Dr White did nothing more than obtain the tax advantage that Parliament intended would flow to someone in her position.”

As a result, the High Court ruled that the arrangement did not constitute tax avoidance.

Crucially, on the facts before the Court, the Commissioner was unable to prove that the anaesthetist’s arrangement included any uncommercial aspects (apart from the failure to pay her a market salary for her professional services). In that regard, the White case is the exception that proves the rule: Tax avoidance is now largely (if not entirely) dependant on the existence of some non-market element/s in the taxpayer’s arrangement. Not coincidentally, it is the only result in favour of the taxpayer. This outcome presumably reflects the absence of any contrivance by the taxpayer that would offend Parliament’s contemplation. As Heath J concluded:

“The fact that the company happened to make a loss should not turn an otherwise acceptable business arrangement into one characterised as artificial or a contrivance. While the effect of the arrangement was (for unforeseen reasons) to negate the need for Dr White to pay income tax, its purpose was not to obtain an impermissible tax advantage.”

It is understood that Inland Revenue has appealed the decision to the Court of Appeal.

6.6 Penny and Hooper

Penny and Hooper, the first appellate level case to apply Ben Nevis, considered further whether the price agreed under an arrangement was a market price. The High Court had earlier ruled in favour of the taxpayer, but this decision was subsequently overturned by the Court of Appeal. Again, the facts in that case are well-known, involving the restructuring of the business of two surgeons from:

- Sole practitioners earning an income of approximately $500,000 per year, into

[(2011) Vol 17:4 NZJTLP 419, 438]

- A company owned by a family trust for the benefit of the surgeons and their respective families, with

- The surgeons becoming employees of their companies, on salaries of approximately $120,000 per year, while the remainder of the profit from their services was retained by the companies and allocated to the trusts, which either:
  - Purchased assets for the benefit of the surgeon, or
  - Made large unsecured and interest-free loans of those profits to the surgeon personally.

The tax effect of the arrangement was that the surgeons paid the highest tax rate of 39 per cent on only their reduced salaries, while the remaining profits were taxed to the company at the corporate rate of 33 per cent (and subsequently allocated fully-imputed to the trusts). This resulted in significant tax savings to the surgeons personally but ensured that they continued to enjoy the economic benefits of the income generated by their personal services.

In the High Court, the Commissioner presented evidence prepared by a specialist accountant that no comparable market
information for orthopaedic surgeons’ salaries in the private sector existed. Further, it was argued that salaries payable in the public sector were not comparable. The basis for rejecting the public sector salaries (in particular, the controlled market in which they are paid) reflects the type of economic analysis that might be used in a typical comparability analysis performed for international transfer pricing.

Similarly, the method used to determine a commercially realistic salary in the absence of a direct benchmark is a type of profit-split method used in transfer pricing analyses as a method of last resort. That is, the market salary was estimated by the Commissioner using the earnings of a self-employed orthopaedic surgeon as a starting point and deducting:

• The arm’s length return payable on the operating costs and contingencies of the practice; and
• The required arm’s length return payable on the investors’ capital,

to determine a residual sum that represented an arm’s length salary.

In contrast, the taxpayer chose not to present evidence to support the commerciality of the salaries as their argument relied on there being no requirement for a market salary.

MacKenzie J in the High Court ruled that the adoption of the company and trust structure was both common and entirely commercial. Furthermore, his Honour accepted the taxpayers’ argument that the absence in the Income Tax Act of a specific requirement for a market salary indicated that proprietors of family companies and trusts were not obliged to pay themselves market rates. On that reasoning, the taxpayers’ arrangements did not offend Parliament’s contemplation.

On appeal, the majority found that the arrangement constituted tax avoidance. [(2011) Vol 17:4 NZJTPL 419, 439]

After reviewing the facts, the majority considered that there were two striking factors that together made the arrangement artificial or contrived. First, the surgeons agreed to voluntarily work for a salary of less than 20 per cent of the market rate, while the profits accrued to the company and trust under their control, and they still enjoyed most of the economic benefits from that income. Second, that agreement was timed to coincide with the introduction of the highest marginal tax rate of 39 per cent in 2000, which gave rise to the substantial tax savings.

While the majority acknowledged that the Income Tax Act does not require that any minimum or market salary be paid, in that case there was no commercial explanation for what the surgeons themselves accepted was an artificially low salary. Importantly, the majority did not rule that the company/trust structure in itself was necessarily tax avoidance. Rather, it was the use of that structure by the surgeons to reduce their personal tax that crossed the line into tax avoidance:

“… the adoption of legitimate legal structures or entities will not be a barrier to a finding of tax avoidance if the arrangements are artificial, contrived, or amount to a pretence.”

While the payment of non-market salaries by family companies or trusts may be justified in some circumstances, there was no commercial rationale for the surgeons agreeing to accept salaries of only one-fifth of the market rate. On that basis, Randerson J held:

“It could not have been within the contemplation of Parliament that a company director / employee could adopt a salary of less than one-fifth of a proper commercial salary and thereby secure significant tax advantages while still receiving, in practical terms, the benefit of the company’s entire net income for himself and his family.”

The minority judgment adopted the reasoning of MacKenzie J that this type of structure was so widely used that it ought not to constitute tax avoidance. Ellen France J ruled that the surgeons were entitled to choose their own business structure and were not required to pay a market salary. Her Honour stated:

“It is trite, but worth repeating, that not all arrangements which produce a tax advantage will constitute tax avoidance. That is
the corollary of the freedom taxpayers have to structure their tax affairs in the most effective way."

While the minority judgment does not justify the commerciality of the surgeons’ low salaries, it concluded that the surgeons “have [not] gained the benefit of specific provisions in an artificial or contrived way. Rather, they have taken advantage of the difference in tax rates in a way that is within the limits of acceptable commercial practice.”

Most significantly, in terms of the tests for tax avoidance proposed by the Supreme Court, it is uncertain whether the surgeons had truly suffered the economic cost of the arrangement. While income under their arrangements was derived by the companies, the evidence confirmed that they retained control over and had received the benefit of income derived from their personal services. Neither [[2011] Vol 17:4 NZJTLP 419, 440] taxpayer appears to have truly suffered the economic cost that would normally result from the sale of a trading business into a separate company.

This case represents the clearest example, to date, of the application of the GAAR to what amounted to a domestic transfer pricing arrangement. The surgeons were related to both the companies and the trusts after the restructure of their affairs, and the Court of Appeal’s analysis specifically considered the non-market nature of the salaries in determining whether the arrangements were uncommercial.

Notably, little evidence was presented on the taxpayers’ behalf to support the arm’s length nature of the salaries actually paid. This omission likely reflects the taxpayers’ argument that there was no requirement to pay a market salary. However, it may also reflect the lack of any direct evidence of a comparable market salary or other suitable benchmark to estimate what such a salary might be. As a consequence, the substantial reduction in the amount earned by the surgeons before and after the restructure appeared inexplicable in terms of a reduction in their personal risk or responsibilities related to the running of their respective practices. Similarly, a reference to external benchmarks, such as salaries paid by hospitals for similar services, did not adequately provide a comparable price for their private services. On the facts, it seems without question that the surgeons agreed to provide their services for a non-arm’s length price solely because of the relationship they had with the counterparties to the arrangement, which is the very essence of transfer pricing.

7.0 TRANSACTIONS INVOLVING “RELATED” BUT NOT “ASSOCIATED” PERSONS

Only the Krukowski, White and Penny and Hooper cases strictly involved transactions between “associated persons” as defined in subpart YB of the Income Tax Act 2007. While that definition was significantly broadened recently, it still applies only to taxpayers that are relatively closely connected by family relationship or ownership. As such, it does not apply to taxpayers whose degree of closeness or control fall, even slightly, below the brightline tests in the definition. Nor does it apply to otherwise unrelated taxpayers who either habitually chose to act together or have chosen to act in concert in a particular instance. Such taxpayers are not “associated” but can generally be described as “related”. The only previous category within the “associated persons” definition that could potentially have applied to such taxpayers was repealed at the time at which the other categories were expanded. That provision previously applied to persons who “habitually act in concert” in relation to specified matters. This category of association was justified by Inland Revenue on the basis that it would:

“target persons who are not formally associated … but who nevertheless have a sufficient connection (by virtue of them consciously acting together on a regular basis) to justify treating them as associated.”

Nevertheless, difficulties with the wording and scope of this category of association had prevented its effective application. The category was therefore repealed “for simplification and rationalisation [[2011] Vol 17:4 NZJTLP 419, 441] purposes”. Nevertheless, as demonstrated in the recent cases, s BG 1 is being used to apply arm’s length pricing or commercially realistic terms to what are non-associated persons. In each case, the court has accepted that the non-associated parties to those arrangements have colluded in or, at least, acquiesced to the charging of non-arm’s length prices or the agreement of non-arm’s length contractual terms. By acting in concert, these taxpayers have combined to put aside the normal market drivers in order to obtain the desired tax advantages. In each case, the taxpayer has effectively engaged in transfer pricing in favour of another party that pays nil or reduced tax:

* In Ben Nevis, it was the lack of actual payment, where the price payable to the charity licensing the forestry land was not due for 50 years.
In Glenharrow, it was the unrealistic prospect of payment to an unregistered taxpayer selling second-hand goods of a price solely payable from profits earned by exploiting the mining license.

In the structured finance cases, it was a foreign counterparty borrowing funds at below-market rate, with an inflated GPF, and calculated to make a pre-tax loss.

In Education Administration, it was a related company registered for GST on a payments-basis charging inflated fees of which only 10 per cent was actually payable.

In Kruzkzener, it was the companies and trusts borrowing funds from external lenders at market rates and on-lending them interest-free to the developer who personally returned nil income for his services for many years.

In Penny and Hooper, it was the proprietors’ family companies and trusts paying a below-market salary for their professional services.

In every case, it was this uncommercial behaviour that warranted the finding of tax avoidance. By contrast, the lack of any uncommercial aspect in White appears to have been crucial to the decision that the taxpayer’s arrangement did not constitute tax avoidance.

On that approach, s BG 1 has become a type of internal transfer pricing mechanism by which the Commissioner freely examines the underlying economics of the taxpayers’ conduct and, where non-market behaviour is identified, reconstructs that arrangement to substitute his own view of the proper price for a supply of goods and services, using the reconstruction power in s GB 1.

Commentators have suggested simply reforming the current transfer pricing rules to encompass both international and domestic transfer pricing. Commentating on the recent cases, they noted:

"the underlying issue appears significantly broader than salaries paid for personal services, as several other recent court decisions clearly confirmed the relevance of non-market transactions in their avoidance deliberations. In this regard, the general principle [that non-market consideration implies avoidance] could potentially be applied to [a] broad range of controlled transactions such as those involving salaries, services, loans, leases, royalties, asset sales, etc. Arguably, under the various recent decisions, the arm’s length standard required for cross border associated party transactions has been effectively ‘imported’ into domestic case law pertaining to anti-avoidance.”

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8.0 CONCLUSION

The Supreme Court decisions in Ben Nevis and Glenharrow mark a significant shift in the direction of tax avoidance jurisprudence in New Zealand. That change has been recognised and applied in all subsequent cases, which have focused on the commerciality of the taxpayers’ arrangements and asked whether the taxpayers have truly suffered the expected economic cost. The parliamentary contemplation test provided by the Supreme Court shares many of the same features as the international transfer pricing regime and, in particular, the functional analyses necessary to support the arm’s length nature of these arrangements. The combination of economic analysis and market pricing suggests that the application of s BG 1 is providing a quasi-domestic transfer pricing regime, albeit one that applies to both associated and non-associated parties.

While this view is controversial, a non-market price and/or the failure to actually pay the agreed price are the only factors common to all recent cases. The Ben Nevis decision has therefore changed the tax avoidance enquiry into a much more factual question of whether the arrangement adopts an arm’s length pricing and complies with market norms. Tax benefits obtained as a result of purely commercial transactions presumably come within parliamentary contemplation, while those obtained as a result of non-market conduct will breach s BG 1. In this way, the analysis of tax avoidance cases mirrors that used in transfer pricing. Accordingly, the signpost of tax avoidance may simply be whether the parties have acted commercially. This conclusion was acknowledged by the Court of Appeal in Glenharrow.
“Chisholm J was not wrong to find tax avoidance on the basis of a grossly inflated valuation. We accept the Commissioner’s submission that transactions at non market value can in some circumstances defeat the intent and application of the Act.”

While conceptually simple, the application of the new parliamentary contemplation test is likely to be, in practice, far from straightforward. Compliance costs for international transfer pricing arrangements can be considerable. Also, the economic analysis necessary under this regime often requires expertise beyond the ability of the taxpayer or their advisor. Is this a path that either the courts or the Commissioner wish to go down for all taxpayers potentially caught by s BG 1?

Determining what economic evidence to collect and the extent to which it is necessary under s BG 1 will create new uncertainties for taxpayers. Despite the fact that Parliament has not chosen to extend the existing transfer pricing regime to include some or all domestic arrangements, the GAAR has been applied as a proxy for such rules. In the absence of a clear legislative requirement as to whether and when a strictly arm’s length approach is required, certainty for taxpayers may never have been further away.

8.1 Post-script

The Supreme Court granted leave for the surgeons’ appeal in Penny and Hooper. This allowed New Zealand’s highest court to reconsider and either clarify or confirm its approach to tax avoidance. Since this article was accepted for publication, the Supreme Court delivered its decision in which it upheld the findings of the Court of Appeal.

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FOOTNOTES

1 This article was accepted for publication prior to the release of the Supreme Court decision in Penny v Commissioner of Inland Revenue[2011] NZSC 95, (2011) 25 NZTC ¶20-073.


3 Examples include the transfer of trading stock and revenue account property (s GC 1), depreciable property (s EE 45), forestry (s GC 2), undervalue leases (s GC 5), and salaries paid to a relative or spouse (s GB 23).

4 The international transfer pricing regime is found in s GB 2 and ss GC 6-GC 14 of the Income Tax Act 2007, but applies only to “cross border arrangements” between associated persons.

5 See s 149A of the Tax Administration Act 1994, as discussed in Vinelight Nominess Ltd v Commissioner of Inland Revenue (No 2)(2005) 22 NZTC 19,519 (HC).


8 This is the terminology and conclusion reached by Craig Elliffe and Jess Cameron “The Test for Tax Avoidance in New Zealand: A Judicial Sea Change” (2010) 16 NZBLQ 440.


10 Now found in s GB 2 and ss GC 6-GC 14 of the Income Tax Act 2007.

11 The New Zealand legislation (ss GC 6-GC 14 of the Income Tax Act 2007) applies to transactions between “associated persons” as defined in s YB 1, but the OECD Transfer Pricing Guidelines and Inland Revenue’s transfer pricing guidelines use the generic term “related parties”.


13 Internal Revenue Code 26 USC, § 482.
In addition, the operation of other tax rules, notably the Working for Families Tax Credit, also incentivised taxpayers to restructure their affairs to avoid paying the top marginal tax rate. A simple example exploiting opportunities under the Working for Families Tax Credit regime can be found in Case Y1(2007) 23 NZTC 13,001 (TRA).

OECD, above n 8, art 9.

Paragraph 1 of the Commentary on art 9.


A sixth method, global formulary apportionment, is mentioned in the OECD Transfer Pricing Guidelines and specifically rejected on the basis that it does not provide arm’s length outcomes. For a discussion of this method, see, for example, Kerrie Sadiq “The Taxation of Multinational Banks: Alternative Apportionment through a Unitary Taxation Regime Aligning with Economic Reality” (2007) 13 New Zealand Journal of Taxation Law and Policy 640.

In general, all the transfer pricing methods require benchmarking of transfer prices to the pricing or profits in uncontrolled transactions (comparable data). However, the profit split method can be applied in a manner in which transfer prices are based on the relative contributions of the related parties to the arrangement, rather than on the pricing or profits in uncontrolled transactions. The reliability of any transfer pricing method will be reduced, however, where it is not possible to support the transfer prices with reference to sufficient comparable data.


Ibid, at [267]-[292]. This process is based on the documentation process developed by the Australian Taxation Office and set out in ch 5 of Australian Taxation Office “Taxation Ruling TR 98/11: Income tax: documentation and practical issues associated with setting and reviewing transfer pricing in international dealings” (Canberra, 1998).

Income Tax Act 2007, s GC 13(1).

Income Tax Act 2007, s GC 13(3).


For a fuller discussion of Inland Revenue’s audit approach, see John Nash and Keith Edwards “Transfer Pricing” (paper presented to New Zealand Institute of Chartered Accountants 2009 Tax Conference, Auckland, 2009).


Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue, above n 28, at 331, 23,211, [105].


Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue, above n 28, at 330-331, 23,211, [102] to [104].

Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue, above n 28, at 329-330, 23,210, [100].

The majority judgment was delivered by Tipping, McGrath and Gault JJ. A plurality judgment reaching the same decision on different grounds was delivered by Elias CJ and Anderson J.
65 Ibid, at 382, 23,248-23,249, [53].


69 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Paris, revised August 2010) at [1.64]-[1.65].


72 Ibid, at 16. Interestingly, having criticised the approach taken by the majority of the Court of Appeal in Penny and Hooper, which applied the reasoning of the Supreme Court in Ben Nevis, that commentator concluded (ibid, at 15): “In terms of the end result ... it is submitted that Randerson J arrived at the correct result but for the wrong reasons."


76 While receipt of the distribution was exempt or relieved from tax in New Zealand, payment of the distribution was characterised as deductible interest in the jurisdiction of the foreign counterparty.

77 There were 29 reported cases between 2005 and 2009 regarding all procedural aspects of the structured finance repo tax avoidance litigation, of which 21 judgments were delivered by the High Court, five by the Court of Appeal and three by the Supreme Court (including leave applications). The Commissioner was entirely or largely successful in each decision.

78 The substantive decisions upholding the Commissioner’s assessments based on tax avoidance are reported as BNZ Investments Ltd v Commissioner of Inland Revenue(2009) 24 NZTC 23,582 (HC) and Westpac Banking Corp v Commissioner of Inland Revenue(2009) 24 NZTC 23,834 (HC).

79 Westpac Banking Corp v Commissioner of Inland Revenue, above n 78, at 23,877-23,878, [174]:[179].

80 Ibid, at 23,899, [316].

81 Ibid, at 23,841-23,842, [12]:[14].

82 Ibid, at 23,902, [337]:[341].

83 Ibid, at 23,901, [336].

84 BNZ Investments Ltd v Commissioner of Inland Revenue(2009) 24 NZTC 23,582 (HC) at 23,674, [526(e)].

85 Westpac Banking Corp v Commissioner of Inland Revenue, above n 78, at 23,937, [595].

86 Westpac Banking Corp v Commissioner of Inland Revenue, above n 78, at 23,940, [620].

87 Westpac Banking Corp v Commissioner of Inland Revenue, above n 78, at 23,939, [611].


89 See Vaimoana Tapaleao “Banks to pay taxman billions” New Zealand Herald (Auckland, 24 December 2009), and Tamsyn Parker “Settlement of $2.2b tax case hits banks hard” New Zealand Herald (Auckland, 29 December 2009). See also Inland Revenue “Structured finance cases settled” (media release, 23 December 2009), announcing that settlement.

91 Education Administration Ltd v Commissioner of Inland Revenue (2010) 24 NZTC 24,238 (HC).

92 Ibid, at 24,247-24,248, [66]-[67].

93 Ibid, at 24,248, [75].


96 Ibid, at 24,573, [42].


98 Kruksiener v Commissioner of Inland Revenue (No 3), above n 95, at 24,575-24,576, [57]-[58].


100 White v Commissioner of Inland Revenue (2010) 24 NZTC 24,600 (HC).

101 Ibid, at 24,614, [69].

102 Ibid, at 24,614, [71].

103 Ibid, at 24,614, [69].

104 However, see White at 24,607, [32]-[35], where the Commissioner alleged that the rental paid for the orchard land by the taxpayer’s company to the taxpayer’s family trust was artificially high and, therefore, significantly inflated the losses available to be offset against the taxpayer’s professional services income. Unfortunately, this allegation appears not to have been included in the Commissioner’s statement of position (SOP) and, therefore, was excluded from being advanced in the challenge proceedings by virtue of s 138G of the Tax Administration Act 1994. Therefore, neither the TRA nor the High Court gave any weight to that allegation. The omission of that potentially significant allegation from the Commissioner’s SOP may ultimately have proved fatal to the allegation of tax avoidance.

105 White v Commissioner of Inland Revenue, above n 100, at 24,614, [75].


107 Commissioner of Inland Revenue v Penny and Hooper (2010) 24 NZTC 24,287 (CA).


109 While the restructuring was implemented at different times, the reduced salaries agreed by each surgeon took effect from 1 April 2000, not coincidentally the same date as the higher marginal tax rate came into effect.


111 Randerson and Hammond JJ.


113 Such as during the start-up phase, when there are insufficient profits, or to fund the purchase of capital assets; ibid, at [126] where Randerson J refers to legitimate reasons his Honour previously discussed at [98].

114 Commissioner of Inland Revenue v Penny, above n 112, at 387, 24,310, [122].

115 Ellen France J.

116 Commissioner of Inland Revenue v Penny, above n 112, at 397, 24,318, [184].


120 See Policy Advice Division of the Inland Revenue Department and New Zealand Treasury Reforming the definitions of associated persons: An officials’ issues paper on suggested changes to the definitions of associated persons in the Income Tax Act 2004 (Wellington, 2007).

121 Ibid, at 30, [4.34].

122 See the comments by Prescott-Haar and Ces “Court of Appeals case confirms that commercially realistic salary is critical to sustain an anti-avoidance attack, but how should commercially realistic consideration be determined? And will the Supreme Court reverse the decision?” (unpublished working paper).

