PRACTICAL PROBLEMS FROM PUBLICATION OF THE COMMISSIONER'S INTERPRETATION GUIDELINES

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Practical Problems from Publication of the Commissioner's Interpretation Guidelines

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1. Introduction

1.1. Commissioner's statements

The New Zealand Commissioner of Inland Revenue issues several kinds of statements that are in effect legal opinions. This article relates to certain public statements formerly known as "policy statements" and now called "interpretation guidelines". The change of name occurred in 1995, when the department was reorganised and two new divisions were formed: Policy Advice and Adjudications and Rulings. "Policy statements" became the responsibility of Adjudications and Rulings. The new name of "interpretation guidelines" was chosen to avoid misleading people into thinking that such statements emanate from the Policy Advice Division.

As a preliminary matter, it is helpful to distinguish interpretation guidelines from other forms of opinions or statements that the Commissioner issues. There are two primary groups of such statements: binding rulings and standard practice statements.

1.2. Binding rulings, determinations, and standard practice statements

Binding rulings, issued under Part VA of the New Zealand Tax Administration Act 1994, are the most formal of the Commissioner's statements. Binding rulings are of three types: public rulings, product rulings, and private rulings. The first two are published but private rulings remain confidential to the taxpayers that apply for them. The Commissioner issues public rulings essentially on his own initiative, in order to clarify some area of law of general interest. Taxpayers apply for product rulings in order to obtain certainty as to the tax consequences of investments that are to be marketed to the public. Private rulings relate to transactions proposed by individual taxpayers. From taxpayers' point of view, the merit of binding rulings is that they can rely on them for the duration specified in the ruling even if the Commissioner changes his mind or a later case shows him to have been wrong.

Akin to rulings are "determinations",[2] which are issued in somewhat similar circumstances but which relate to two specific areas of the Income Tax Act only: the calculation of income and expenditure in respect of loans and other financial arrangements and to certain matters in respect of petroleum mining. They are separate from rulings largely for historical reasons, in that Parliament first provided for determinations in

[2] Tax Administration Act 1994 Part V.

limited areas where they were particularly necessary, before later enacting legislation for a general rulings process.

Standard practice statements differ from binding rulings and determinations in several respects. First, the Commissioner issues them pursuant to his inherent administrative powers as Commissioner, rather than pursuant to specific statutory authority. Secondly, they are not binding on the Commissioner, though the Commissioner and the Inland Revenue Department endeavour to abide by them. Thirdly, standard practice statements are produced by Inland Revenue's Operations Division. Standard practice statements concern the department's administrative practices or set out policy that is to be applied in the exercise of discretions that the Income Tax Act vests in the Commissioner.

The functions of the Operations Division are as its name suggests. It includes most of Inland Revenue's personnel. Inland Revenue's other two main divisions, Policy Advice and Adjudications and Rulings, were mentioned earlier. They are much smaller and more specialised. Binding rulings are one of the responsibilities of the Adjudications and Rulings division. The other is to perform in-house quasi-judicial assessments of disputes between the Commissioner and taxpayers. This process often results in the settlement of disputes; if not, one objective is to narrow the area of focus before taxpayer objections go to court.

1.3. Reason for policy statements and interpretation guidelines

Interpretation guidelines and their forerunners, policy statements, in a sense fall between binding rulings and standard practice statements. Like standard practice statements they are not binding and are issued under the Commissioner's inherent powers. On the other hand, like binding rulings they are the responsibility of the Adjudications and Rulings Division. A further similarity to rulings is that they deal with difficult points of law, and often read rather like legal opinions.

The Commissioner issues interpretation guidelines when it appears to be desirable to offer an element of certainty, or, at least, to minimise uncertainty, in respect of a general area of law. Although they are not legally binding on the Commissioner he generally follows them administratively.

One advantage of a guideline over a public ruling is that in circumstances where the Commissioner does not wish to make a statement as a public ruling that is certainly to be binding come what may, a guideline is able to serve. Nevertheless, one should not make too much of this factor.

The Commissioner expects to follow interpretation guidelines, and does not issue them with one eye on the possibility of having to act contrarily to them.

A second reason for issuing an interpretation guideline rather than a public ruling is that public rulings can apply only to an "arrangement"[3] that is "specified in the ruling".[4] This limitation restricts the subject matter of possible public rulings. It is true that "arrangement" is widely defined, and that "specified", presumably, must relate not to a single specific arrangement but to any arrangement of a specific kind; nevertheless, the Commissioner's powers to issue public rulings must clearly be employed in relation to arrangements that are defined with some specificity. It follows that public rulings are not suitable vehicles to convey the Commissioner's views on general matters such as what sort of arrangements amount to tax avoidance or how taxpayers should address questions of form and substance.

1.4. Process for developing interpretation guidelines

The process for developing interpretation guidelines is similar to the process that the Adjudications and Rulings Division employs for preparing public binding rulings. Three people are appointed to each project. An analyst is the principal researcher and author for the project. A manager helps the analyst and provides guidance throughout. A "sign off" has the responsibility to challenge the robustness of the work, its technical reasoning, and its logic. Sometimes a fourth person is appointed as adviser where there are specialised issues that need additional expertise.

An initial "directions meeting" identifies issues and suggests promising avenues for research. The three or four officials hold later meetings as the project progresses. Before a ruling or a guideline is produced the analyst prepares a detailed issues report, which includes conclusions that must be agreed by the manager and approved by the "sign off".

Like public rulings, interpretation guidelines are subject to extensive consultation, both within and outside the department. Consultation includes circulation to professional bodies, advertising drafts for comment in Inland Revenue's *Tax Information Bulletin*, and placing copies on the department's website. Statements can remain as "exposure drafts" for long periods, sometimes years.

In exercising both its adjudication and its rulings functions, the Adjudications and Rulings Division is careful to consult

[3] Id s 91DB(1).
[4] Id s 91DC(1)(b).

formally with the Policy Advice Division of Inland Revenue and also with relevant segments of the Operations Division. However, the ultimate decision in respect of applications for private or product rulings rests with the Adjudications and Rulings Division. The Division attempts to apply an objective interpretational approach rather than an approach that is based on fiscal policy or on an endeavour to protect the revenue. This approach carries over into the division's work on interpretation guidelines.

1.5. Quality of interpretation guidelines, public rulings, and product rulings

On the face of it, there is much to be gained from the Commissioner's practice of publishing interpretation guidelines. Guidance to taxpayers and to officials and insights into the department's thinking all appear to be good things. But these initial reactions are questionable, particularly where guidelines relate to avoidance, to form and substance, or to other areas where there is generalised uncertainty. The major problem is that where the Commissioner tries to set rules within areas that Parliament has left vague or covered by general principle he is apt inadvertently to offer taxpayers routes to plan around those rules.

A full study of the quality of policy statements and interpretation guidelines that the Commissioner has issued would be a large task. This paper considers three statements and suggests that they suffer from a number of shortcomings. The three statements are an exposure draft on form and substance, an interpretation guideline on shams, and a policy statement on avoidance.

2. Interpretation guideline exposure draft on form and substance in taxation law

2.1. Introduction

In 1998, the Inland Revenue Department published an exposure draft of an interpretation guideline, "*Form and Substance in Taxation Law.*"[5] As the draft explains:

> Interpretation guidelines are intended to clarify general points of interpretation that are causing, or may cause, difficulty for practitioners, taxpayers, and Inland Revenue. An interpretation guideline is Inland Revenue's opinion as to the better view of the law. That view is developed from an appreciation and assessment of the law on a particular topic, as gleaned from the cases.

[5] New Zealand Inland Revenue Department document reference IG9703 (1998).

The draft finishes with this warning:

> Draft items produced by the Adjudications and Rulings Business Group represent the preliminary, though considered, views of the Commissioner of Inland Revenue.
>
> In draft form these items may not be relied on by taxation officers, taxpayers, and (sic, or?) practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

Although the document is an "exposure" draft that is qualified by the explanations set out above, it is understood that it describes the manner in which the department interprets the law. There are several deficiencies in the department's approach.

2.2. Form and substance analysis

A cardinal shortcoming of the exposure draft is that its structure assumes that a bipartite division of form and substance is a sufficient analytical framework for the task that it addresses. In particular, it does not divide "substance" into legal substance and economic substance. It says, "The [courts'] only significant departure from [a formalistic] approach is when the essential genuineness of a transaction is challenged" (by alleging that the transaction is a sham). This remark calls for two comments.

First, it does not sufficiently recognise that when a court deploys a form/substance analysis the exercise is, as it were, a sub-set of the discipline of statutory construction. The question in every tax case is, "On its true construction, does the statute capture the gain or allow the expense in question?". As Lord Hoffman put it in *Macniven v Westmoreland Investments Ltd*,[6]

> There is ultimately only one principle of construction, namely to ascertain what Parliament meant by using the language of the statute. All other "principles of construction" can be no more than guides which past judges have put forward, some more helpful or insightful than others, to assist in the task of interpretation. [There do not exist] overriding legal principle[s], superimposed on the whole of revenue law without regard to the language or purpose of any particular provision.

By way of exception, in New Zealand and Australia section BG 1 of the Income Tax Act 1994 and Part IVA of the Income Tax Assessment Act 1936 do in fact constitute "overriding legal principles superimposed on the whole of revenue law" or, at least, on income tax law, but these exceptions do not gainsay the general applicability of Lord

[6] [2001] 2 WLR 377 [29].

Hoffman's dictum. The exposure draft attempts to achieve a certainty that is illusory. In doing so it fails to appreciate that its subject matter is statutory construction, which involves more a series of approaches than a group of rules.

2.3. Search for legal substance

Secondly, when a transaction is challenged as a sham and not genuine, or as being in substance something different from what its form suggests, the courts have essentially one response. This response is to seek the true legal obligations and rights that the transaction imposes or confers on the parties to it.

Courts often explain this exercise by adopting one of two bipartite frameworks. The first is the form/legal substance dichotomy. When the form of a transaction, or the label that the parties give to the transaction, is different from the true legal substance of the transaction, then the courts construe the transaction according to the true legal rights and obligations that it creates, that is, according to its true legal substance. An example is *Ensign Tankers (Leasing) Ltd v Stokes*.[7] In that case, the House of Lords held that a transaction that was constructed as a non-recourse loan was in legal substance a partnership, and that it should be treated as a partnership for tax purposes.

The second bipartite framework entails distinguishing between a transaction's true legal substance and its economic effect. A recent example is *CIR v Wattie*.[8] In that case, the Privy Council held that a payment that the Commissioner of Inland Revenue argued was a rent subsidy was in legal substance a premium paid by a landlord to attract a tenant, notwithstanding that in economic effect the payment was just the same as a rent subsidy. Being a premium, the payment was a non-taxable capital receipt, whereas the rent subsidy would have been a revenue item.

2.4. Three elements in tripartite framework

Two features of these alternative bipartite arrangements require noting. First, the concept of legal substance is common to each framework. Secondly, whichever framework is appropriate to the case at hand, the correct answer is nearly always the same: the court must analyse the transaction according to its legal substance and the true legal rights and obligations that it creates. If the first framework is used, the courts reject form in favour of true legal substance. If the

[7] [1992] 1 AC 655 HL.
[8] [1999] 1 NZLR 529, 18 NZTC 13,991 PC.

second framework is used, the courts reject economic substance in favour of legal substance. (The significance of the word "nearly" in the expression "nearly always the same" is explained in the next section of this article.)

The result is that a conspectus of the two types of cases, that is, cases like *Ensign Tankers* and cases like *Wattie*, reveal three relevant categories: form, legal substance, and economic substance. The courts reject the first and third in favour of the second. This principle does not mean that the first and third categories are never correct. Rather, and subject to what is said in the succeeding paragraphs, they are correct only if they happen to coincide with legal substance, with the parties' true rights and obligations. Thus in *Wattie*, a legal form (a premium) did in fact coincide with legal substance (a premium) and the Privy Council rejected analysis according to economic substance that would have led to classifying the payment as a rent subsidy. In *Ensign Tankers*, economic substance (a partnership) did in fact coincide with legal substance (a partnership) and the House of Lords rejected form (a non-recourse loan).

2.5. Limits of tripartite analysis

The tripartite framework of legal form, legal substance, and economic substance is useful and will explain and rationalise many cases. However, it is not a complete answer. It is not a rule of law but a principle of construction. In some cases the framework does not operate. For instance, in *Southern Railway of Peru Ltd v Owen*, Lord Radcliffe said:[9]

> The answer to the question what can or cannot be admitted into the annual account is not provided by any exact analysis of the legal form of the relevant obligation. In this case, as in the *Sun Insurance*[10] case, you get into a world of unreality if you try to solve your problem in that way, because, where you are dealing with a number of similar obligations that arise from trading, although it may be true to say of each separate one that it may never mature, it is the sum of the obligations that matters to the trader, and experience may show that, while each remains uncertain, the aggregate can be fixed with some precision.

The matters in question in the *Southern Railway* case were contingent obligations to disburse severance pay pursuant to contracts of employment, the obligations being individually unquantified. In the passage quoted, Lord Radcliffe both expressly rejected reliance on the legal form of the transactions and impliedly rejected legal substance, in that the

[9] [1957] AC 334, 357 HL.
[10] *Sun Insurance Office v Clark* [1912] AC 443 HL, footnote added.

form and substance of the unquantified obligations coincided.) Instead, he chose the economic substance that "experience may show … can be fixed with some precision".

Analysis such as that of Lord Radcliffe has been relatively rare in tax cases except where the statute uses general terms like "profit". Like Lord Radcliffe, judges may take such drafting as an invitation to call commercial concepts in aid to flesh out the meaning of words that do not have a precise legal meaning.

2.6. Influence of *Westmoreland Investments* case

As a result of *Macniven v Westmoreland Investments Ltd*, this kind of reasoning may become more widespread. In that case, Lord Hoffman employed this reasoning in his explanation of *WT Ramsay Ltd v IRC*[11]. His Lordship said:[12]

> Thus in saying that the transactions in the *Ramsay* case were not sham transactions, one is accepting the juristic categorisation of the transactions as individual and discrete and saying that each of them involved no pretence. They were intended to do precisely what they purported to do. They had a legal reality. But in saying that they did not constitute a "real" disposal giving rise to a "real" loss, one is rejecting the juristic categorisation as not being necessarily determinative for the purposes of the statutory concepts of "disposal" and "loss" as properly interpreted. The contrast here is with a commercial meaning of those concepts. And in saying that the income tax legislation was intended to operate "in the real world", one is again referring to the commercial context which should influence the construction of the concepts used by Parliament.

In this passage, Lord Hoffman rejects both "juristic categorisation" (which no doubt includes legal form) and "legal reality" (that is, legal substance) as determinative. Instead, he chooses a "commercial meaning", that is, economic substance. Most people see *Macniven v Westmoreland Investments Ltd* as narrowing the scope of the *Ramsay* principle, which conclusion is probably correct as far as it goes. But the case may also widen the area within which courts will opt for economic over legal substance.

2.7. Self-cancelling transactions

The preceding paragraphs have tried to show that the exposure draft's relatively simple dichotomy of form and substance is insufficiently nuanced and too inflexible to serve as a useful tool of analysis of tax cases. The draft itself illustrates the point in its discussion of a practical example

[11] [1982] AC 300 HL.
[12] [2001] 2 WLR 377 [41].

formed by a pair of opposing transactions that balance one another in both legal and economic substance. The draft specifically denies the possibility of considering the transactions together as a self-cancelling matrix. The example is:

> P purchases some assets from M for $100,000. P and M then enter into a simultaneous put and call option agreement under which:
> - M has the right to buy the assets back for $110,000 (call option);
> - P has the right to sell the assets to M, also for $110,000 (put option).

The draft states that these options must necessarily be treated as separate transactions, even though they are part of a single agreement. It is possible that there are circumstances where the opinion in the draft would be correct. However, there are not enough secondary facts in the example to decide whether a court would consider each transaction separately and give each transaction full effect, or whether it would conflate the transactions into a single, self-cancelling matrix. Indeed, there are no secondary facts given in the example.

Tax officials faced with cases where the primary facts match the balancing transactions in the example could be forgiven for following the analysis in the draft and assuming that the law will inevitably require each transaction to be given separate effect.

2.8. Self-cancelling in the Magnum case

Interestingly, some people seem to have adopted the approach just described in analysing the Magnum scheme in the Wine Box papers. People may recall that the core transactions in the Magnum scheme were an agreement to sell a promissory note, and another agreement to buy the same note. The Magnum scheme's pair of transactions were, if anything, less closely inter-related than the put and call options in the exposure draft's example. The differences are first that the Magnum transactions were not formally part of a single agreement and secondly that, while one party was the same in both Magnum transactions, the second parties to the two transactions were not identical but were sibling companies in the same group.

On their facts, there is a tenable argument that the Magnum transactions were self-cancelling and did not have the effect that was purported by their authors, to put the matter at its lowest. In fact, in *European Pacific Banking Corporation v Television New Zealand*[13] the Court of Appeal went further, and, taking into account the secondary facts of the Magnum

[13] [1994] 3 NZLR 43.

scheme, held that Television New Zealand had established a seriously arguable case that the whole scheme was iniquitous. (Iniquity was relevant because the plaintiff's claim for an injunction was based on an allegation that Television New Zealand was relying on stolen documents. One defence was that the transactions involved iniquity; that is, the plaintiff did not come to equity with clean hands.) In the later case of *Peters v Davison*[14] the Court of Appeal confirmed its earlier opinion that the Magnum promissory note transaction could be ineffectual because one leg of the transaction cancelled the other.

Comparing the exposure draft's example with the Magnum scheme illustrates that form/substance analysis is much more subtle, elusive, and impressionistic than would appear to be the case to a reader of the draft. Although the draft purports to be no more than a draft, and is subject to correction, the ordinary course of events would not necessarily see the necessary corrections made. If there is reliance on the period of exposure of the draft to provoke professional comment that would identify errors, that reliance may well be misplaced. Nine times out of ten, the view that the draft espouses will suit the taxpayer rather than the Commissioner. It would be a most altruistic practitioner from the private sector who would seek to correct the draft.

2.9. Causes for concern

One does not want to be unfair to the department in criticising a document that is only an exposure draft. On the other hand, the draft was published on 4 June 1997, and remains an exposure draft at the time of writing. By the end of 1998 had attracted only five submissions.[15] None of them made the points made in this article. It is unrealistic for the department to rely on voluntary public comment to correct this kind of document.

The status and likely use of the draft are a matter for concern. The document is in essence a pedagogic text on how to approach transactions by using a form/substance analytical framework. But in status, and in some of its language, the document is a draft statement of the law as the Commissioner understands it. There are several problems here. They stem from the fact that the form or substance question, as part of the law of statutory interpretation, is more a tool of argument

[14] [1999] 2 NZLR 164.

[15] I McKay, AP Molloy, J Prebble & J Waugh, *Tax Compliance*, Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance, Wellington 1998, 136

or analysis than it is a statement of law. Moreover, it is a deceptive tool, in that, like other principles of statutory interpretation, judges often state it in firm, almost dogmatic terms, whereas in fact it is infinitely flexible and elusive.

The matters discussed in the last paragraph give cause for concern about the users of the interpretation guideline. If people are knowledgeable about tax law, they will understand that, despite its form, the statement can in only a limited sense function as a statement of the Commissioner's view of the law. But these people will already know enough about tax law that they will either not need to use the statement, or, worse, they will be able to use it against the Commissioner, picking on passages that can be deployed against him.

If people's knowledge of tax law is such that they need the statement to inform them about the form/substance distinction there is every risk that they will be misled. In difficult cases, the form/substance distinction is a matter of shadings of grey. The draft statement does not paint a picture that is purely black and white, but it does give an impression of much more certainty and logic than in fact exist. A tax official relying on the statement to help in analysing and categorising a difficult transaction could well come to the wrong conclusion.

Revising and correcting the statement is not the answer. The statement is not really an "interpretation" of a difficult or ambiguous rule of tax law, and hardly qualifies to be called an "interpretation guideline". As mentioned earlier, it is more in the nature of instruction in the use of a particular analytical technique. Because the technique is a tool, in close cases it can be used to argue either side. Publishing an explanation of such a technique as a formal statement of the Commissioner's view of the law can inadvertently give tax advisers in the private sector an argument that, in substance, does not exist. Further, it can cause officials to reach incorrect conclusions. As has been explained, it may be that the drafters of the statement themselves came to an incorrect conclusion in respect of self-cancelling transactions.

A further cause for concern is that, although the draft is subject to revision after exposure, at publication it stated the Commissioner's then (and apparently still) current "considered views". Have those views affected any private binding rulings that have been issued in recent years? Have they influenced decisions about completed transactions that have come to the attention of inspectors? One cannot answer these questions, because private rulings are not published, and because decisions about individual taxpayers are confidential.

2.10. General reflections on interpretation guidelines

In conclusion, consider the purpose of interpretation guidelines that set out not interpretations of law but, in effect, instructions or information on how to go about methods of legal reasoning. To the extent that users are Inland Revenue Department staff, the purpose is commendable and necessary: it is most important for staff to be educated in methods of legal reasoning. But are interpretation guidelines appropriate vehicles for such education? If interpretation guidelines are to fulfil the function that their name implies, they must be reasonably concise and dogmatic. Legal reasoning has many qualities, but concise dogmatism is not one of them. Where it is a question of education or instruction of officials on methods of legal reasoning, the conventional vehicles of textbooks, articles, and class instruction are more appropriate. There is no obvious need for a particular approach to be sanctioned by the Commissioner. Indeed, the expense of settling an agreed, concise, statement must be considerable, compared with the greater latitude that is appropriate in an educational context.

There must also be concern about directing interpretation guidelines of the kind under discussion to taxpayers and practitioners. Non-specialists who do not know how this kind of statement fits into the total context of the law would be ill advised to rely on them. Specialists do not need them and are apt to turn them against the Commissioner.

3. Interpretation guideline on shams

3.1. Bipartite analysis

The second statement to be considered is an interpretation guideline entitled *"Sham" – meaning of the term*, which was published in 1997.[16] The guideline is an item of three or four pages, much along the lines of a short expository article that one might find in a professional or scholarly journal or as part of a chapter in a textbook.

The guideline mentions relevant law, draws certain conclusions, and gives some examples. It suffers from the shortcoming that its analysis of shams takes place within an analytical framework that is not wholly adequate. It adopts the same bipartite approach as the exposure draft on form and substance that has just been discussed. Loosely, courts talk in terms of contrasting the form of a transaction with its

[16] (1997) 9 *Inland Revenue Department Tax Information Bulletin*, issue 11, p 7.

substance. The guideline adopts this dichotomy, but a two-part framework is not sufficiently refined to elucidate the cases. As explained, in this context the courts use a framework that has at least three levels: economic substance, legal substance, and legal form. Generally speaking, courts adopt the second level, legal substance, as correctly representing the effect of transactions for the purpose of tax cases.

3.2. No halfway house

A second difficulty is that the guideline keeps to the assumption that there is no halfway house between a sham and an effective transaction. There are plenty of dicta in the cases that appear to support this principle, and it is accurate as far as it goes. But the principle must be understood within a wider context. That context is that, above and beyond the doctrine of sham, the courts do in fact decline to accord to certain categories of genuine, non-sham, transactions the effect that those transactions purport to have. In strict logic, these impugnable transactions are sub-categories of genuine transactions, but for practical purposes they may well be thought of as forming a kind of halfway house between sham transactions and genuine transactions.

The main inhabitants of this quasi-halfway house are mislabelled transactions, self-cancelling transactions, and transactions that, when interpreted in context, have an effect different from the initial impression that the reader gains from one or more of the documents.[17] (The interpretation guideline mentions the third category by implication in its discussion of Richardson J's judgment in *Re Securitibank (No 2)*[18], but it does not explore the implications of the category in a manner that is sufficiently informative.)

The difficulty with the Department's interpretation guideline is that most readers would take it to be comprehensive in scope, (in the sense of covering or referring to the whole relevant field, rather than in the sense of being a fully detailed analysis). The guideline reinforces this impression by quoting the "no halfway house" principle, which has misled a good many readers of judgments in the past. The problem is compounded by the fact that the guideline appears to be a general, authoritative statement. In contrast, reported judgments can be misleading enough, but at

[17] See J. Prebble "Criminal Law, Tax Evasion, Shams, and Tax Avoidance: Part II – Criminal Law Consequences of Categories of Evasion and Avoidance" (1996) 2 *New Zealand Journal of Taxation Law and Policy*, 59, 63 - 66.
[18] [1978] 2 NZLR 136.

least most readers of law reports appreciate that statements of principle in judgments can be taken as generally authoritative only within limits.

4. Policy statement on section 99 of the Income Tax Act 1976

4.1. Introduction

The Commissioner's policy statement on the application of section 99 of the Income Tax Act 1976, the general anti-avoidance section, was published in 1990.[19] The statement seems to have governed much of the department's approach tax avoidance since it was published.

Section 99, now section BG 1, was last amended as to substance in 1974, though there have been several changes of detail as the section has been moved from one Act to another. The 1974 wording was carried forward into the 1976 Act as section 99. The section was disaggregated into several components in the 1994 Act. It is now found in section BG 1, section GB 1, and in several definition provisions in section OB 1. Nevertheless, the essential terminology remains as it was in 1974 and the 1990 policy statement continues to apply to it.

It is understood that the Commissioner intends to withdraw the statement in due course, but not until a substitute has been completed.

4.2. Objective/subjective test

A number of passages in the policy statement give cause for concern. For instance, there are passages that have the effect of imposing burdens on officials who try to deploy section BG 1 where those burdens are not inherent in the text of the section itself. Correctly, the statement recognises that the section BG 1 test is objective: does the impugned arrangement avoid tax?; not, did the parties try to avoid tax? However, some of the text of the statement is framed in terms that could be interpreted as employing a subjective test. An example is,

> The evaluation will be with a view to concluding whether one can predicate whether the arrangement was implemented in its particular way so as to achieve an income tax advantage.[20]

This passage is apt to take inspectors' attention away from arrangements themselves, and to encourage them to seek a tax avoidance purpose entertained by the people responsible for

[19] Taxpayer Information Bulletin no 8, February 1990, appendix C.
[20] Id 3.

implementation. The section does not require the Commissioner to establish such a purpose.

4.3. Four-step test

Secondly, the statement sets out a four-step analytical framework that is said to be required of "the Commissioner's approach" to section BG 1 cases. This approach is said to require a careful and thorough analysis of:[21]

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

One problem with the phraseology of the four steps is that it seems to accept that the Commissioner has the burden of proof, which is not so. A second problem is that step (d) asks whether an arrangement that may already have been determined to involve more than merely incidental tax avoidance at step (c) "frustrates the underlying scheme and purpose of the legislation". The underlying scheme and purpose of the legislation is not mentioned in section BG 1. That is not to say that underlying scheme and purpose are irrelevant to a section BG 1 inquiry, but tax inspectors accept too heavy a burden if they are required to elevate underlying scheme and purpose to an independent test.

There is a further problem with the four-step test. Taxpayers began to use it to raise procedural objections to the Commissioner's assessments. Had the Commissioner conscientiously worked through each of the self-imposed steps? Did the reasoning in respect of each step withstand scrutiny? For a few years, it began to look as though the four steps would become four trip-wires that would give substance to judicial review applications in almost any section BG 1 case. Perhaps fortunately for the Commissioner and for the general body of taxpayers, this argument reached the Privy Council in the case of *Miller v CIR*,[22] a tax shelter appeal that drew a notably long bow. In that case, the policy statement was called the "CPS". The taxpayers argued that it was ultra vires for an inspector to come to a conclusion in an avoidance

[21] Id 2.
[22] [2001] 3 NZLR 316 PC.

case without going through the four steps of the CPS. Lord Hoffman retorted:[23]

> … the question of whether an arrangement is void against the Commissioner under s 99(2) is not a matter for his discretion or policy. The Act says that an arrangement falling within the terms of the section "shall be absolutely void". Likewise, the Commissioner is under a statutory duty to reassess the taxpayer's income to counteract any tax advantage. Discretion enters into the matter only as to the method of calculation by which the Commissioner discharges that duty.
>
> The CPS nevertheless reassured taxpayers that, before invoking s 99, the Commissioner would undertake a careful and thorough analysis of the meaning and purpose of the statute and the purpose or effect of the arrangement. He would consider whether it was a fair and reasonable inference that one purpose was tax avoidance. He would decide whether the scheme frustrated the underlying scheme and purpose of the legislation.
>
> ….
>
> … their Lordships do not think that the CPS was intended to lay down conditions at all. … the parts of the document relied upon by the appellants do [no] more than to reassure the public that the Commissioner and his officers will think very carefully about whether s 99 applies to any particular case. But his statutory duty is to reassess the taxpayer in any case in which s 99 applies and this duty cannot be made subject to internal conditions.

Thus, at least the policy statement does not constitute a procedural handicap for the Commissioner when it comes to litigation.

4.4. Examples of arrangements

The policy statement contains an annex that gives several examples of arrangements that might amount to avoidance. It blesses some of them and condemns others. As an example of the former, take, for instance, number 4, an arbitrage scheme that contrives to grant a tax preference to foreigners when acquiring shares in petroleum mining companies. The policy statement accepts that this scheme escapes section BG 1 even though section 160A of the 1976 Act in terms awarded the preference to New Zealand residents only. (Alternatively, depending on the price at which New Zealand residents sell their shares to foreigners, the scheme involves not arbitrage but New Zealand residents obtaining a preference for investing in petroleum mining shares that they own for only two weeks.)

On the basis of a formalistic analysis, the policy statement determines that the scheme in example 4 is not vulnerable to

[23] Id 330.

attack under section BG 1. This conclusion is doubtful. At any rate, if the example is correct it follows that section 160A did not achieve its intended effect. If so, the section should have been amended. If section 160A was deficient in the manner that the Commissioner explains in the statement then, of course, the Commissioner had no option but to assess people on the basis of section 160A's correct meaning, deficient though it was. But what are the merits of publishing a statement that highlights this assumed deficiency and that invites taxpayers to exploit it? In any event, it is curious that the Commissioner should have given way on such a scheme without testing the position in court.

5. Conclusion

5.1. Anti-avoidance rules

Since it was published, the 1990 policy statement seems to have had considerable influence. It may be part of the explanation for the infrequency with which the Commissioner has invoked section BG 1 from the time of its re-drafting in 1974.

From the point of view of sound tax administration it is questionable whether Commissioners should issue policy statements or interpretation guidelines about general anti-avoidance rules, although there is always a good deal of pressure for them to do so. Throughout the history of the New Zealand and Australian general anti-avoidance rules, taxpayers, and sometimes the courts, have asked Parliament for more details. What sorts of transactions are caught? What are acceptable? In New Zealand, Parliament has resisted this pressure.

In 1985, in *Challenge Corporation v CIR*,[24] *Woodhouse* P explained:

> [T]here can be no doubt that when the provision was amplified and given its present statutory form by Parliament in 1974 the deliberate decision was then taken that, because the problem of definition in this elusive field could not be met by expressly spelling out a series of detailed specifications in the statute itself, the interstices must be left for attention by the Judges. …. [I]nherent in the approach taken by Parliament is an assurance that some expressed judicial misgivings as to the proper role of the Court concerning the earlier legislation have been misplaced.
>
> … In New Zealand the Courts must now ensure that the anti-avoidance provision as it stands is given that purposive

[24] [1986] 2 NZLR 513, 534 line 30.

> construction which will enable it to do its work in the balanced but effective way intended for it.

It is a curious irony that the Commissioner's policy statement fills a lacuna that Parliament intentionally left empty. The more detailed rules there are within the overall ambit of a general anti-avoidance rule, the greater the risk of people circumventing them. Formally, the Commissioner's statement does not constitute binding rules, but in practice the department is reluctant to deploy section BG 1 against taxpayers who have brought themselves within an example that is said to escape the section.

There is a parallel, though possibly not a close one, between the Commissioner's policy statement and the considerable detail that Australia added to Part IVA of the Income Tax Assessment Act 1936 when the Commonwealth Parliament replaced the former section 260 of that Act. The reason for having a general anti-avoidance rule is that income is an imperfect tax base. Parliament cannot foresee all the possible stratagems that taxpayers may employ to minimise their tax. The response is a general rule. The less general the rule becomes, the less effective it is. This consideration may explain some of the Australian Commissioner's failures.[25]

5.2. Interpretation statements in general

In the nineteenth century it was said that in the Court of Chancery no case was certain but none hopeless. While an exaggeration, there remains some truth in this statement when applied to tax cases today. This is particularly so in respect of cases that depend on the application of a somewhat flexible form of reasoning rather than on relatively black letter law. Examples of such flexible forms of reasoning include: applying the principles of statutory interpretation; drawing the line between capital and revenue items; applying the statutory anti-avoidance rule; and analysing facts according to the form/substance distinction (in effect a sub-set of statutory interpretation).

It is very difficult for anyone who is trying to manage a department of state according to the law to allow for the level of flexibility, and even of inconsistency, that is inherent in the jurisprudence tax cases (not of individual cases, but of tax cases taken as a body). For efficiency, it seems to make sense to try to produce reasonably formal, certain rules to govern officials' decision-making. However, one result, seen in the *Interpretation Guideline on Shams*, the Exposure Draft of the

[25] E.g., *Eastern Nitrogen Ltd v FCT* (2000) 46 ATR 474 Fed Ct, Full Ct; *FCT v Metal Manufacturers Ltd* [2001] FCA 365, 46 ATR 497, Fed Ct, Full Ct.

Interpretation Guideline on *Form and Substance in Taxation Law*, and the *Policy Statement on Section 99*, is that blunt instruments are used to try to achieve refined objectives.

It is easier to identify the problem than it is to suggest practical solutions. The Commissioner can only work within the budget that he has and with the staff that are available. As a minimum, however, it is suggested that the Commissioner should consider issuing interpretation guidelines very sparingly, if at all, in areas where the law depends primarily on an approach or method of reasoning, and where relevant facts vary infinitely from case to case.