NEW ZEALAND TAXATION AND TAXATION LAW

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This paper offers an historical, economic, constitutional, and contextual survey of the New Zealand tax system. The focus is on income tax, but the paper also briefly describes the "goods services tax", the name given to the New Zealand value added tax. The focus is on domestic taxation, but there is a brief survey of international elements.

The paper considers several innovations that have spread from New Zealand to other jurisdictions: the general anti-avoidance rule, or "GAAR", the imputation system for taxing companies and shareholders, and a fringe benefits tax collected from employers rather than employees. It explains two innovations that are yet to be adopted elsewhere, at least on a widespread basis: (i) the "accruals" rules, which cause most income and expenditure in respect of financial arrangements to be calculated on a yield to maturity basis, and (ii) certain pooling rules, which allow taxpayers to set off between themselves under-estimated and over-estimated tax (the tax being consequently under- or over-paid), thereby minimising interest otherwise payable to the Crown.

The paper demonstrates how the concept of income in New Zealand tax law fits into a model of a crude, or standard, idea of income, modified by rules that either mitigate the harshness of that concept or that prevent people from exploiting its vulnerabilities.

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I INTRODUCTION AND CONTEXT

A Scope

This paper attempts a description of New Zealand's fiscal system in general and of its income tax law in particular. It touches on New Zealand's value added tax, known as the "goods and services tax" and on the country's budget, but the focus is on income tax law.

B History and Constitution

New Zealand is a former British colony. It is a member of the Commonwealth of Nations, a constitutional monarchy, and a sovereign jurisdiction. The head of state is the Queen in Right of New Zealand, a monarch whom New Zealand shares with the United Kingdom and fifteen other countries of the Commonwealth. The Queen is represented in New Zealand by a Governor-General, appointed on the advice of the Prime Minister, by convention approximately every five years.

Along with the United Kingdom and Israel, New Zealand is one of three countries that have no written constitution, or, more precisely, no single codified constitutional document. The reason is that New Zealand shares and inherits the constitutional history of the United Kingdom, where the major upheavals and revolutions that characterised the development of many countries occurred in the seventeenth century, before it became customary to mark changes in style of government with a written constitution. Further, New Zealand is a single jurisdiction, not the product of a federation, federation being another reason for countries to adopt codified constitutions.

The government is organised on the Westminster system. That is, by convention the Prime Minister and Ministers are Members of Parliament and responsible to Parliament rather than to the head of state. Not being subject to a codified, written constitution, Parliament is sovereign, with no theoretical limit on its powers of legislation. There is only one chamber. New Zealand observes the doctrine of separation of powers in respect of the judiciary, which is independent, but the legislature and the executive come together in the person of the Prime Minister and Ministers.

Voting is on a mixed member proportional representation basis. That is, some Members of Parliament represent constituencies. Others are chosen from ranked party lists, with the objective that party representation in Parliament should fairly closely reflect numbers of votes won. In practice, governments are coalitions of a large party and one or more small parties.

C Economy

New Zealand is a small, developed, open economy, with relatively few restrictions on economic activity or on international trade and investment. New Zealand is a net importer of capital. The Reserve Bank governs monetary policy, independently of the government. The country always scores well on comparative indices of transparency and lack of corruption. New Zealand is unusual among developed economies in being heavily dependent on primary production, international trade, and tourism. The manufacturing sector is small. Most agricultural, forestry, and fisheries production is exported as commodities rather than as processed products.

On the spending side New Zealand is similar to most developed democracies, with the largest components being social welfare, including pensions, (26 per cent of government expenditure), health (17 per cent), and education (15 per cent). The largest projection for increases is in respect of old age pensions, which is a matter of concern, but the position is less marked than in many countries. The major difference between New Zealand and comparable countries is that New Zealand spends rather less on defence (3.3 per cent).[1] In recent years, spending by the public sector has amounted to approximately 40 per cent of gross domestic product, a little lower than the average in the OECD.[2]

D Taxation and the Constitution

New Zealand's history and constitutional form have led to a number of important results in respect of taxation. The first is that that there is no provision for a tax to be struck down as unconstitutional. Secondly, the taxing power of the Crown (that is, the executive or government) by convention must be renewed by legislation every year, a legacy of the constitutional upheavals in the United Kingdom in the seventeenth century. In practice this means that each year one tax amending statute or another includes a formal provision that renews the Crown's taxing power. Thirdly, with a unicameral parliament and with ministers being Members of Parliament, New Zealand finds it is relatively easy to make parliamentary time for tax legislation, though the need to negotiate with coalition partners can cause delay.

There are several second-level consequences. First, Parliament typically manages to adopt several tax amendment statutes in any year. Secondly, if a

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1 Mark Hansen, Luke Bjerring, and Ryan Delaney, "Where are my Taxes?" www.wherearemytaxes.co.nz, last consulted 3 September 2014.

2 New Zealand Treasury.

suddenly disclosed loophole needs very urgent attention legislation can be drafted and passed within a very few days, though that is most uncommon. Thirdly, most of New Zealand's tax laws are embodied in primary legislation, with relatively few laws in regulations, executive orders, or other secondary legislation.

E The Judicial Committee of the Privy Council

Until the Supreme Court Act 2003, which came into force in 2004, the final court of appeal from New Zealand was the Judicial Committee of the Privy Council, in London. The Judicial Committee (often called the "Privy Council") was the final court of appeal for countries of the British Empire. Most of its members were judges of the House of Lords, the final court of appeal of the United Kingdom. As colonies became independent and developed their own legal systems they one by one established their own final courts of appeal.

Because of its relatively small population (which implies in absolute terms not many disputes requiring adjudication and, in turn, a pool of relatively few judges from which to draw appointments) New Zealand deferred this step until 2003, although the country had enjoyed home rule since 1852.[3]

Opinions differ as to precisely when New Zealand can be said to have become fully autonomous. One view is that the date is 1907, when the United Kingdom Parliament declared New Zealand to be a "dominion". Another is that the date is 1947, when the United Kingdom Parliament passed the New Zealand Constitution Amendment (Request and Consent) Act 1947. From that year New Zealand was formally legally independent as well as independent in substance. There are intermediate possibilities, but what is certain is that maintaining the Judicial Committee as New Zealand's final court of appeal did not dilute the sovereign autonomy of the country; it was a matter of New Zealand's choice.

This history is more important for taxation than for some other areas of law. The reason is that because of expense there were relatively few appeals from New Zealand to the Privy Council: rarely more than ten in a year. Tax cases were relatively over-represented because of the funds involved. As a result, some of New Zealand's most important tax appeals were decided by the same judges who sat in the House of Lords.[4] In addition, there was cross-fertilization between the tax laws of former British colonies in that for some decades the Judicial Committee was also the final court of appeal for Hong Kong, India, Australia, Canada, and

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3 The New Zealand Constitution Act 1852 (UK).

4 Now the Supreme Court, as a result of Part 3 of the Constitutional Reform Act 2005 (UK), which came into effect in 2009.

other jurisdictions. It was common, and remains common, for New Zealand courts to cite decisions of the superior courts of former British colonies and, especially, from the Judicial Committee.

F The Common Law

Like other countries with a British legal heritage, New Zealand inherited the common law from the former colonial power along with Britain's constitutional history. Compared with the civil law, the common law is more fine-grained, is more formal and legalistic, is less substantive, and relies more on the doctrine of precedent. These qualities are all reflected in the nature of New Zealand's tax law as applied by the courts. And because in theoretical principle the common law is a seamless web, its heavy reliance on precedent means that New Zealand courts do not hesitate to look to jurisprudence from other countries, particularly from Australia and the United Kingdom.

A notable feature of the common law is that it has no doctrine of abuse of law, neither in respect of law in general nor in respect of tax law in particular. As Lord Tomlin put it in the case of *Duke of Westminster v Commissioners of Inland Revenue*:[5]

> Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.

The result is that in principle taxpayers were historically free to construct their contracts and other legal arrangements in ways that minimise tax even though the legal form of the arrangements might be quite different from the economic substance that lay beneath. Over time, New Zealand, along with the United Kingdom and other Commonwealth jurisdictions, has progressively eroded this principle, both by specific and by general anti-avoidance rules, and indeed by judicial reasoning,[6] but it remains an éminence grise in the background.

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5 *Duke of Westminster v Commissioners of Inland Revenue* [1936] AC 1, [1935] All ER Rep 259, 51 TLR 467, 19 TC 490 at [1936] AC 19, 19 TC 520 per Lord Tomlin (HL)

6 See, eg, *Commissioners of Inland Revenue v. McGuckian* [1997] UKHL 22; [1997] 1 WLR 99; [1997] 3 All ER 817; [1997] 1 WLR 991 per Lord Steyn.

The same point may be observed from many perspectives. For instance, it is often relatively easy to change a gain from revenue to capital, or an expense from capital to revenue, in either case with the result of reducing assessable income.

A concomitant of this consideration that is often unrecognised is that the doctrine of precedent operates less precisely in tax cases than in the run of the common law. Because it is often not possible to identify just what overall principle lies behind earlier decisions, the reasoning of courts in tax cases is often stipulative rather than logical, which results in contradictory authorities probably more often in tax cases than in other areas of law.[7]

II TAXES, STATUTES, RATES, AND ADMINISTRATION

A The Chief Taxes and their Legislation

New Zealand's main tax is the income tax, first imposed by the Land and Income Assessment act 1891. Like most tax legislation the statute was regularly amended and periodically re-codified. A major rewriting, reorganising, and renumbering project taking over ten years culminated in the Income Tax Act 2007, which remains the legislation that applies in 2014, at the time of writing this paper. The Act is organised into alphabetically designated parts and sub-parts, with numbered sections and sub-sections within the sub-parts. The objective is to make it easier to add further provisions with elegant re-numbering, and without resort to such drafting infelicities as "section 275ZZC",[8] which had become a feature of amending legislation. This objective has largely been successful. The Income Tax Act contains the on-going statutory rules of income tax law. Annual amendment Acts stipulate the rates of tax.

The second tax is a value added tax, called in New Zealand the goods and services tax. This tax was introduced by the Goods and Services Tax Act 1985 and came into force in 1986. It replaced former sales taxes and by dint of several increases has grown in relative importance. As at 2014 it is charged at fifteen per cent. There are excise taxes on some products, principally petrol, tobacco, and alcohol, but few tariffs.

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7 See, eg, John Prebble, "Ectopia, Formalism, and Anti-avoidance rules in Income Tax law", (1994) in W. Krawietz N. MacCormick & G.H. von Wright (eds) Prescriptive Formality and Normative Rationality in Modern Legal Systems, Festschrift for Robert S. Summers, Duncker and Humblot, Berlin, 367-383; John Prebble, "Philosophical and Design Problems that Arise from the Ectopic Nature of Income Tax Law and their Impact on the Taxation of International Trade and Investment", (1995) 13 Chinese Yearbook of International Law and Affairs, 111-139; and John Prebble, "Income Taxation, a Structure Built on Sand" (2002) 24 Sydney Law Review 301.

8 A notional section, invented to illustrate a form of numbering that can emerge after numerous amendments.

In addition to the two statutes mentioned, the Tax Administration Act 1994 establishes the Commissioner of Inland Revenue and the Inland Revenue Department. It sets out procedures for lodging returns of income, assessment, binding rulings, offences, penalties, and so on.

B Tax Disputes and Litigation

Taxpayers may dispute decisions of the Commissioner, in particular assessments of tax. Procedures introduced in 1996[9] are designed to resolve as many cases as possible without litigation before the courts. The procedure is that the taxpayer and the Commissioner exchange written statements,[10] with documents by way of "disclosure notices"[11] to ensure full disclosure of facts. The Commissioner offers taxpayers a non-mandatory conference where the parties and their counsel can discuss the case with a view to obtaining agreement. (This can involve simply explaining the law to taxpayers who are mistaken.) If the parties cannot agree the dispute goes to the Disputes Review Unit, within the Inland Revenue Department. An adjudicator within the unit rules on the dispute. Taxpayers who disagree may challenge the Commissioner's assessment before the courts.[12]

The first level of court is the Taxation Review Authority, governed by the Taxation Review Authorities Act 1994. Proceedings before a Taxation Review Authority are broadly similar to civil proceedings before first-tier courts, except that they are confidential.

Appeals lie from the Taxation Review Authority to the High Court, Court of Appeal, and Supreme Court. Major cases may proceed directly to the High Court. Once in the general court system tax disputes are no longer confidential. The 1996 policy of trying to resolve as many disputes as possible without litigation has been fairly successful: there are fewer appeals to the courts on the merits of tax disputes than was formerly the case, though there tends to be more litigation on procedural grounds: litigation that rarely succeeds as far as the taxpayer is concerned.[13]

C Notable Features of the New Zealand Fiscal System

The remainder of this paper discusses New Zealand taxation law in some detail. First, however, it is worthwhile to highlight several features of the New Zealand

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9 Act no 56 (1996).

10 Tax Administration Act 1994 Part 4A.

11 Tax Administration Act 1994 s 89M.

12 Tax Administration Act 1994 Part 8A.

13 The former procedure of appeals to the Privy Council in London is discussed above, at chapter I E.

fiscal system that may not be unique, but that are thought generally to be rather rare.

First, nearly ten per cent of government tax revenue comes from the corporate sector, a higher fraction than in most developed economies. The reason is that in the mid-1980s New Zealand abolished nearly all industrial and agricultural incentives and other tax preferences. As a result, and subject to what will be said below about the absence of tax on capital gains, the income tax base is relatively comprehensive and the effective tax rate for business profits is often not far below the statutory rate.

Secondly, in addition to the broad base for income profits that has just been mentioned, the base for New Zealand's goods and services tax is also very comprehensive. There is a single rate with almost no exemptions:[14] in particular, New Zealand eschews the common exemptions or reduced rates for food, clothing, books, educational fees, and so on.

On the other side of the leger, New Zealand is notable among developed economies in having no general capital gains tax. There are two major exceptions: (i) all gains in respect of most loans and other financial arrangements are treated as being on revenue account and taxable, most of them on a accruals basis, rather than on the basis of receipts or realizations,[15] and (ii) speculative and some other gains on land transactions that some tax systems treat as being on capital account are taxed as income.[16]

D Tax Administration

Generally speaking, tax administration in New Zealand is well integrated; taxpayers use the same identification number for income tax and goods and services tax and several social programmes are integrated with income tax collection.

Matters that concern large taxpayers include the institutions of tax pooling accounts and tax pooling intermediaries.[17] The need for tax pooling arises from timing questions in the estimation and payment of tax. Tax on business profits is paid provisionally during the year of earning, with calculation and settlement in the following year. Broadly speaking, taxpayers estimate their liability. If they under-

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14 Goods and Services Tax Act 1985 s 8(1).

15 Income Tax Act 2007 Subpart EW.

16 Income Tax Act 2007 s CB 6 to s CB 23B.

17 Tax Administration Act 1994 s 15O to s 15T.

estimate and therefore under-pay their provisional tax they incur interest. If, as a precaution, they over-estimate and over-pay they earn interest, but at a much lower rate. There is consequently an opportunity for arbitrage between taxpayers.

Tax pooling intermediaries are authorised to pool the credits and debits of numbers of taxpayers, allowing the credits of some taxpayers to offset the debits of others. Through an intermediary, a taxpayer who has under-paid provisional or other tax can buy over-paid tax from another taxpayer. Typically, prices are more than sellers would receive from Inland Revenue by way of interest on over-paid tax, but less than the interest rate that purchasers would incur in respect of under-paid tax. In principle, any taxpayer who must pay provisional tax (primarily business taxpayers) might be interested in pooling, but because of transaction costs only larger concerns become involved.

E Non-revenue Elements of the Tax System

The New Zealand income tax system is partially integrated with the social welfare system, primarily in two ways. First, because the Inland Revenue Department is more efficient at collecting funds than other state agencies it undertakes responsibility for certain non-tax collections, such as repayments of loans to students and payments by people (usually fathers) who fail to support their dependants.

Secondly, some social welfare payments are delivered through the tax system, particularly what are in effect negative taxes on taxpayers with low incomes but with dependant children: or with quite high incomes if they have enough children. Because such payments, and other allowances, abate with increasing incomes they result often in effective tax rates that sometimes approach 100 per cent, creating the poverty traps that are familiar in many modern economies.

F Rates of tax

As with most countries, New Zealand's rates of tax vary depending on the needs of the economy and on the political complexion of the government. That said, since the 1990s variations have not been marked and have generally been confined to the top personal rate. As at 2014 the rates were:

Income tax, individuals

up to $14,000	10.5%
from $14,001 to $48,000	17.5%
from $48,001 to $70,000	30%
$70,001 and over	33%

Income tax, entities

companies	28%

trusts	33%
partnerships (transparent)	zero
Goods and services tax	15%

There is no zero-rate band for the first tranche of earnings. The reasons are (a) that many people with earnings of less than, say, $10,000 in a year are second-income earners within their households, either children or partners, and (b) that where an individual or family relies on a single very low income it is more efficient for the social welfare system to top the income up than for a zero-rate band to operate.

The rates set out here are nominal. As mentioned above, social welfare entitlements can cause effective rates to be much higher. On the other hand, tax planning can sometimes reduce taxpayers' effective tax rates well below their nominal rates. Broadly speaking, the more income one derives, and the more complex its form, the more possible it is to reduce tax by restructuring,

III THE GOODS AND SERVICES TAX

A Origins, Name, and Policy

The goods and services tax came into force in 1986, pursuant to the Goods and Services Tax Act 1985. The Act was part of a suite of major economic reforms that transformed the New Zealand economy from closed to open, with concomitant effects for New Zealand society that continue today.

The tax is a value added tax on the European model. It was called a "goods and services tax" for political reasons. Historically, New Zealand has always been an exporter of unprocessed or lightly processed primary products. Political parties often have a policy of encouraging exporters to strengthen the economy by processing and manufacturing agricultural and forestry products in order to "add value" to exports. It was thought that to introduce a "value added" tax at the same time would send conflicting messages.[18] A second reason for choosing "goods and services tax" as the name is that it describes the subject matter of the tax (as does "income tax") rather than the means of collection, and may therefore be more easily understood than "value added".

Before 1986 the principal indirect taxes were customs duties and a sales tax, generally collected at wholesale level. Both forms of tax applied unevenly and cascaded from one transaction to the next, multiplying their effects, with uneven results for different parts of the economy. There were few, if any, effective taxes

18 The author was involved in New Zealand tax reform at the time. This and other information in this chapter of the paper come from his personal knowledge.

on services. As goods and services tax was introduced customs duties were very substantially eliminated or reduced and the sales tax was abolished.

As mentioned,[19] New Zealand's goods and services tax has a single rate and almost no exemptions, which features are calculated to minimise its distorting effects. The government was able to introduce a tax without the usual exemptions or reduced rates for food, books, children's clothing, and so on because at the time New Zealand was fighting its way out of a very severe fiscal crisis. All sectors of the economy suffered. Thus, it was hard for one pressure group or another to gain traction. Another factor was that the government embarked on a well-planned and effective information campaign, which enabled the new tax to be embedded with much less difficulty and opposition than one might have expected.

The goods and services tax started at ten per cent in 1986. Since then, it has been increased, in two steps, and in 2014 now stands at 15 per cent:[20] not high in comparison with European levels, but nevertheless a very effective rate when one considers that the tax covers virtually all its possible base. Part of the policy of the increases has been to balance the fiscal system more away from direct and towards indirect taxation. New Zealand considers it better to address the regressive effects of a consumption tax by social assistance for the poor rather than by exemptions or by reduced rates on food, books, children's clothing and so on that would be available to everyone.

B Structure

The purpose of the goods and services tax is to tax domestic consumption. As with most value added taxes, therefore, the New Zealand value added tax zero-rates exports.

There are no exceptions apart from domestic rents, most financial services, the supply of precious metals, and the supply of donated goods by charities and other not-for-profit organisations.[21]

Domestic rents are exempt in order to align the fiscal treatment of renters with the treatment of people who live in owner-occupied homes. Since the latter do not pay for their occupancy there is no tax base on which to charge them goods and services tax. Renters should be no worse off.

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19 Above, at chapter II C.

20 Goods and Services Tax Act 1985 s 8(1).

21 Goods and Services Tax Act 1985 s 14.

Financial services are exempt because of the difficulty of working out a system to tax them. For instance, in respect of interest charged by a bank, what portion is pure interest and what portion is the bank's fee for organising and administering the loan? The supply of precious metals is exempt because to a considerable extent precious metals are substitutable for money.

A final exemption is in respect of donated goods. The exemption means that when people donate goods to second-hand shops run by charities there is no exaction of tax on the sale of the goods. One could tax the consumption of donated goods by customers of charity shops, but that policy would have the appearance of double taxation, since donors have already paid tax on the goods when they purchased them. It seems better to exempt the supply. The sums involved are small, and there are no obviously comparable transactions that, by comparison, are unfairly treated.

C Method of Operation

Businesses with turnovers in excess of a certain threshold must register for goods and services tax.[22] Others may register. For instance, exporters may register voluntarily in order to recover input tax.

Goods and services tax is charged on an invoice basis,[23] though certain businesses with low turnover may use a cash basis. Most taxpayers report two-monthly, one monthly for businesses with large turnovers. People with small turnovers may opt for six-monthly returns.[24]

New Zealand does not suffer from wide-scale fraud like European carousel transactions, but there is a certain amount of fraud involving manipulation of registration and inflating of values.

IV LAW OF INCOME TAXATION

A Original Concepts

New Zealand's income tax was introduced by the Land and Income Assessment Act 1891. There are frequent amending statutes, sometimes as many as five in a year. From its inception, the Act was reorganised and re-numbered at intervals of about twenty years, culminating in the major rewriting and re-codification of 2007, which was mentioned in chapter II A.

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22 Goods and Services Tax Act 1985 s 51.

23 Goods and Services Tax Act 1985 s 9.

24 Goods and Services Tax Act 1985 s 15.

The basic approach for New Zealand income tax statutes has been to make all kinds of income prima facie subject to the same rules, with exceptions only where specified. That continues to be the approach of the Income Tax Act 2007, though there are many exceptions. For instance, there are special rules for long-cycle industries such as forestry,[25] petroleum mining,[26] and life assurance.[27]

Judicial interpretation of the New Zealand legislation has followed at least some of the patterns that were established in United Kingdom courts in the nineteenth and early twentieth centuries. Notably, the default meaning of "income" is the ordinary meaning of the word, or, at least, what judges think is the ordinary meaning, rather than what an economist or an accountant might mean by "income". Formerly, judges were apt to quote the circular and uninformative aphorism of Lord Macnaghten:[28] "Income Tax, if I may be pardoned for saying so, is a tax on income." This approach remains embedded in the Act. For instance, capital gains, windfalls, gifts, and gambling winnings are generally excluded from the concept of income; generally speaking income is not recognised until it is realized;[29] and losses in past years may be brought into account only as permitted by the Act,[30] not by virtue of interpreting the concept of "income". It is instructive to think of income for purposes of the modern statute as a relatively crude concept, overlaid by many pages of legislation.

B The Concept of Income in the Twenty-First Century

Broadly speaking, the statutory overlay mentioned in the previous paragraph takes two forms: provisions that mitigate the harshness of a crude income tax, and provisions that frustrate, at least to some extent, taxpayers' ability to exploit either (i) the shortcomings of a crude concept of income or (ii) the mitigating rules just mentioned. Such provisions may be thought of as specific anti-avoidance rules, in contrast with New Zealand's general anti-avoidance rule, which is addressed later in this paper.[31]

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25 Income Tax Act 2007 ss CB 24 and CB 25 (receipts) and subpart DP 1 (deductions).

26 Income Tax Act 2007 subpart CT, and see ss DT 5 to DU 1 in respect of deductions and EJ 12 to EJ 18 in respect of timing.

27 Income Tax Act 2007 subpart EY.

28 *London County Council v A-G* [1901] AC 26 at 35, (HL).

29 Chapter II C mentions a significant exception.

30 Income Tax Act 2007 Part I.

31 Below, chapter VII.

C Examples of Mitigating Provisions

Examples of provisions that mitigate the harshness of a crude income tax include rules that permit the deduction of allowances to recognise the depreciation of capital assets used in earning income.[32] An annual tax on income, as understood by nineteenth century judges, did not permit deductions for depreciation.[33]

A second example is the imputation system for taxing companies. The imputation system ensures that company income is taxed only once, rather than first to the company and secondly to the shareholder. Chapter V B of this paper addresses the imputation regime.

Allowances for depreciation and the imputation system for company taxation are relatively simple in concept, but both require many pages of legislation,[34] first to set out how the regimes work and secondly to prevent taxpayers from exploiting them to avoid tax.

D Examples of Specific Provisions to Frustrate Tax Avoidance

Many provisions that frustrate taxpayers' ability to exploit the shortcomings of the concept of income prevent taxpayers from changing gains from revenue, which is taxable as income, to capital, which is not. A particular example is Income Tax Act 2007 section CC 1(2)(c), which stipulates that a premium charged as the price of granting a lease is taxable as income. The reason for section CC 1(2)(c) is that for most taxpayers a premium is a capital sum, being the price of land or of an interest in land, whereas rent will always be taxable as income. From the perspective of a landlord, however, premiums and rent are fungible, apart from timing differences. It follows that landlords are tempted to persuade tenants to suffer larger premiums in return for enjoying lower rent. Section CC 1(2)(c) prevents landlords from benefiting from this arbitrage opportunity by ensuring that premiums are just as taxable as rent.

Examples of provisions designed to prevent taxpayers from taking advantage of rules that mitigate the harshness of a crude income tax are perhaps even more abundant. The thick hedge of anti-avoidance rules that surrounds the imputation system of company taxation is a good example.[35]

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32 Income Tax Act 2007 subpart EE.

33 *Coltness Iron Co v Black* (1881) 6 App Cas 315 (HL); *Kauri Timber Co Ltd v CT* [1913] AC 771 (PC, NZ) (consumption of capital not a revenue debit).

34 Income Tax Act 2007 Subpart EE (depreciation) and Part O and much of Part L (imputation).

35 See chapter V B.

E The Concept of Income for Tax Purposes

There is not space for a full study of the nature of assessable income for New Zealand taxation purposes, but descriptions of some of the more significant aspects may be helpful. By way of a preliminary, income is calculated in the same manner for all taxpayers, bearing in mind that not all taxpayers can derive every sort of income. For instance, only individuals can earn wages and salaries. Thus, subject to the point that has just been explained, the same rules apply to individuals, companies, trusts, and partnerships. Bearing these considerations in mind:

- First, income is in the end a net concept: essentially receipts less expenses incurred in earning the receipts. One says, "in the end" because the statute is framed in the opposite sense. That is, all receipts are prima facie to be brought into account for tax purposes,[36] with the only deductions being those that the Act specifically permits.[37] Exceptionally, employment income is taxable in gross, in that no deductions are allowed.[38] The reason for this prohibition, which applies to employment income only, is pragmatic. Compliance and administration costs are much reduced if deductions are prohibited in respect of income from employment. In practice, the prohibition does little injustice in that employers pay for most or all of the expenditure necessary for their staff *qua* staff. Parliament introduced the prohibition in the mid-1980s, at the same time as substantially reducing tax rates. The reduction in rates delivered a great deal more benefit to taxpayers than the detriment occasioned by denial of deductions in respect of employment income.
- Income must be a gain; so, for instance, the principal of a loan is not income because a loan entails a concomitant obligation to repay. Whether a loan is secured is not relevant for this purpose.
- Oddly, there is no general rule that where a sum that has been deducted in calculating assessable income that sum must be included in income if the sum is recovered or replaced.[39] Nevertheless, there are so many statutory

36 Income Tax Act 2007 s CB 1(1).

37 Income Tax Act 2007 Part D.

38 Income Tax Act 2007 s DA2 (4).

39 *Federal Commissioner of Taxation v Rowe* (1987) 187 CLR 226 (HCA).

rules that reverse the general rule in one situation or another[40] that there is almost no scope for this default, background rule.

- In most circumstances there must be a realization before income is recognised, with a major exception in respect of interest and other gains in respect of loans and other financial arrangements, which must be accounted for on a yield-to-maturity[41] accrual basis (with exceptions for most financial arrangements of individuals who are not in business).[42]
- Since income taxation operates from year to year a crude income tax system may not permit taxpayers to carry losses forward from previous years. Most income tax statutes have exceptions. New Zealand permits both individuals[43] and companies to carry losses forward indefinitely until exhausted. Special rules apply to companies, which are calculated to frustrate attempts to traffic in losses. To be permitted to carry losses forward and to subtract loses in calculating assessable income of future years companies must maintain a minimum continuity of equity participation of 49 per cent, in respect of both voting and value.[44]
- Gains from barter are taxable if earned in the context of a business or other income-generating activity,[45] but, by virtue of a nineteenth century approach to income, (a) only if convertible to cash,[46] and (b) only at the value at which conversion is possible,[47] which, for goods, in practice means the second-hand value. The primary beneficiaries of these rules were employees who received fringe benefits free of tax or at low effective tax rates. The Income Tax Act 2007 addresses this position by imposing a

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40 Income Tax Act 2007 s CG 1 (depreciation recovery), s CG 2 (remissions), s CG 4 (certain recoveries), and s CG 6 (recovery by way of insurance.

41 "Yield to maturity" calculates the value of a bon or other financial arrangement, including all payments of interest and principal from the present time to the maturity of the bond, allowing in addition for the time value of money.

42 Income Tax Act 2007 Subpart EW. See also chapter II C.

43 Income Tax Act 2007 s IA 3 (4) and s IA (4).

44 Income Tax Act 2007 s IA 5.

45 *Gold Coast Selection Trust Ltd v Humphrey* [1948] AC 459 (HL); *Laidler v Perry* [1966] AC 16; 42 TC 351 (HL).

46 *Tennant v Smith* [1892] AC 150 (HL).

47 *Wilkins v Rogerson* [1961]1 Ch 133; 1 All ER 358 (CA).

special fringe benefit tax,[48] devised by Tim Robinson,[49] also a primary author of the imputation system for company taxation.[50]

- The overall economic effect of fringe benefit tax is to operate as an income tax on the value of fringe benefits, but for practicality the tax is imposed on employers. The tax grosses up the value of a fringe benefit to the sum that represents the value of the income receipt that yields a net value after tax equivalent to the value of the benefit. The objective is that fringe benefits, which workers receive without deduction of tax (in effect, gross) should bear the same effective tax rate as wages and salaries, which workers receive net after deduction of tax.
- On the expenses side, there is no general provision to deduct losses on black hole expenditure, which includes, for example, expenditure in respect of a proposal to acquire a capital asset where the expenditure is wasted, whether because of a change of plan or otherwise. Tax law treats this expenditure as capital and non-deductible, even though it is wholly lost and does not result in the creation of an asset. Accounting, however, would write such expenditure off in preparing the year's profit and loss account. While there is no general provision for deduction of such expenditure there are a number of specific provisions.

V BUSINESS AND INVESTMENT STRUCTURES

A Introduction

Apart from individuals, who can invest on their own behalf or can carry on business as sole traders, New Zealand recognises companies, trusts, partnerships, joint ventures, mutual and cooperative associations, certain Maori authorities, and a number of other business or investment structures.

The individual sole trader is the simplest. He or she calculates assessable income by adding receipts and subtracting deductible expenses, and then pays tax on the gross profit. The net profit, after tax, belongs to the sole trader. As will be explained in the paragraphs that follow, the main difference between the taxation of different business entities is the difference between partnerships and companies. Partnerships are treated as transparent, with partners bearing their own tax on their share of profits, whereas companies are independent taxpayers in their own right.

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48 Income Tax Act 2007 s RD 25 to s RD 63.

49 Author's knowledge.

50 See chapter V B.

B Companies

Companies vary from very small, one-person concerns to large, listed entities, but, apart from look-through companies, to be mentioned, tax laws apply to them all in more or less the same manner. That is, having derived and paid tax on profits companies can then distribute dividends and at the same time attach imputation credits to the dividends.

The imputation system is an example of a mitigating regime of the kind mentioned in chapter IV C of this paper.

Until the late 1980s, company taxation followed the company law concept of a corporation. That is, like the general law, tax treated companies as separate legal entities. Following the approach of the general law, company taxation levied tax twice on the same income, first in the hands of the company and secondly in the hands of shareholders, when income was distributed as dividends. This former system is known as the "classical" system of company taxation. The 2007 Act avoids the unfairness of the classical system and taxes corporate income only once, using the imputation system.

Under the imputation system, both company profits and dividends remain separately taxable, but a company may "impute", that is, credit to its shareholders, tax that it has paid. When shareholders receive dividends they receive imputation credits at the same time. Shareholders then credit their share of the company tax imputed to their dividends towards the tax that they individually owe in respect of those dividends. The Act regulates the imputation system through statutorily required memorandum accounts, where companies record tax paid to the Inland Revenue and tax credited to shareholders.[51] For instance, penalties apply if companies purport to impute more tax to their shareholders than the memorandum account shows that they have paid to the government. The imputation system was proposed by Matt Benge and Tim Robinson in their book, *How to Integrate Company and Shareholder Taxation* (1986).[52]

Among other rules that apply to company taxation, there are provisions for companies that are owned by the same interests to consolidate their accounts for tax purposes and, for simplicity, to be treated as a single company.[53]

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51 Income Tax Act 2007 Part O.

52 Matt Benge and Tim Robinson *How to Integrate Company and Shareholder Taxation* (1986) Institute of Policy Studies, Victoria University of Wellington, ISBN 0864730535.

53 Income Tax Act 2007 subpart FM.

Thick hedges of anti-avoidance rules surround these consolidation rules and, indeed, surround all rules that mitigate what would otherwise be the result of simply taxing companies as independent persons. Rules around the imputation system of company taxation that was described above are a good example. Indeed, most of the provisions in Part O of the Income Tax Act 2007, which governs the various memorandum accounts that are associated with company taxation, may be thought of as rules to prevent taxpayers from exploiting opportunities for arbitrage or avoidance that might otherwise be present in an imputation system. For instance, section OA 8 provides that a company declaring dividends may impute tax to its shareholders only when it maintains 60 per cent continuity of shareholding. If shareholding continuity drops below this threshold, tax credited in memorandum accounts declines to zero, leaving no credit to impute. The object is to prevent trafficking of imputation credits between different groups of taxpayers.

C Closely Held Companies

Businesses with relatively few owners face a dilemma. On one hand, owners may wish to obtain the advantages of limited liability and other benefits that come with corporate status. On the other hand, there is the disadvantage of opting into the more complex income tax requirements that apply to companies. Some tax regimes provide a special tax status for companies with relatively few owners, often called "closely held companies". The New Zealand close company regime provides for what are called "look-through companies".[54] This regime replaces an earlier regime for "qualifying companies",[55] which turned out to contain weaknesses that could be abused for tax avoidance purposes.

The look-through companies regime is hedged about with many rules to address such abuse, but, broadly speaking, the regime's effect is to enable shareholders to treat their companies as transparent for their own income tax purposes, but to operate them as companies for commercial purposes and for the tax purposes of other people. For instance, goods and services tax and pay-as-you-earn withholding rules that apply to remuneration of employees apply to look-through companies.

Look-through companies are limited to five or fewer shareholders, though relatives count as one shareholder. Companies, apart from other look-through companies, may not be shareholders.

For the income tax purposes of its shareholders, and in proportion to their interests in the company, the regime treats the shareholders of a look-through

54 Income Tax Act 2007 subpart HB.

55 Income Tax Act 2007 subpart HA.

company as carrying on the activities of the company personally, as holding its property, as being party to arrangements entered by the company, and as doing whatever the company does.[56] In effect, therefore, the regime treats the company as a partnership for tax purposes.

Perhaps the most important anti-avoidance rule for look-through companies relates to losses. The basic rule is that shareholders may set the losses of look-through companies off within their own tax accounts in the same manner as sole traders or partners can set their businesses or investment losses off against income from other activities. But there is a limit. Shareholders may set off look-through company losses only to the extent of their "basis" in the company.[57] A shareholder's basis comprises essentially the sum that the shareholder has at risk in the company by way of capital contribution or loans. Where losses exceed the shareholder's basis they must be carried forward within the look-through company, to be set off against profits of later years, if any.[58] This loss limitation rule is designed to frustrate tax plans that generate inflated costs, perhaps by over-valuation of the subject-matter of expenditure, funding those costs by loans or credit that are either non-recourse or essentially so.[59]

D Trusts

As explained, like most tax systems, New Zealand taxation treats profits derived by companies as two separate incomes, of the company and of the shareholder. The imputation system, as it were, partially glues the two streams together again and thereby addresses the injustice of double taxation that otherwise results.

Like many common law countries, New Zealand treats trust income differently from the manner in which it treats company income, not as two income streams but as a single stream that is taxed either to the trustee or to the beneficiaries but not to both.[60] Broadly speaking, if trustees distribute income to beneficiaries in the same year when the trustees derive the income the beneficiaries pay tax at their personal rates. If trustees retain trust income they pay tax at a special trustee rate, currently a flat rate of 33 per cent. The same rules apply to distributions from fixed trusts and

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56 Income Tax Act 2007 s HA 1(4).

57 Income Tax Act 2007 s HB 11.

58 Income Tax Act 2007 s HB 12.

59 For an example of such a tax plan see *Ben Nevis Forestry Ventures Ltd & Ors v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 (SC), sometimes known as the *Trinity* case. Some participants in the Trinity tax plan employed qualifying companies as their investment vehicles, qualifying companies being the predecessors of look-through companies.

60 Income Tax Act 2007 subpart HC.

to distributions from discretionary trusts. Trustees file returns of tax on trust income that are separate from their personal income tax returns. Having a trustee rate at 33 per cent, the same rate as the maximum marginal rate for individuals, means that individuals cannot minimise tax by shifting income to trusts and contriving for it to be taxed at trustee rates.

Like companies, trusts are difficult to fit into a tax system. Further, people have used trusts to minimise taxes since mediaeval times, and continue to do so. As a result the Income Tax Act 2007 contains a good many provisions calculated either to make trust taxation work more efficiently or to limit the ways in which people can exploit trusts for tax purposes. The following sub-chapter will mention selected details of these provisions, though omitting many qualifications and exceptions.

E Selected Details of Trust Taxation

First, requiring trustees to distribute income to beneficiaries within the year of derivation can be impractical. Accordingly, the Act gives at least six months' grace in order to allow for making up accounts before income must be allocated to beneficiaries.[61]

Secondly, some rules, such as that described in the next paragraph, depend on whether or how the settlor is related to a beneficiary who derives income under a trust. But many New Zealand trusts are settled initially by strangers, such as one's solicitor, who contribute only a nominal amount. Accordingly, the Act makes the definition of "settlor" depend on transfers of substantial value to the trust, whether directly or indirectly.[62] Nominal and formal settlors are not counted.

Thirdly, in order to take advantage of the lower rates of tax that younger people often enjoy, taxpayers are sometimes tempted to shift income to family trusts and from the trusts to beneficiaries who are their children or grandchildren. The Act partially addresses this practice by providing, in effect, that when trusts are settled by people who are *in loco parentis* or in similar relationships to beneficiaries, then while the beneficiaries are under sixteen years of age, income that they derive from the trust in question is taxed at trustee rates, not at their personal rate.

Finally, there are rules to prevent New Zealand residents from using foreign trusts to shelter offshore income. Chapter VI F of this paper addresses those rules.

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61 Income Tax Act 2007 s HC 6(1B).

62 Income Tax Act 2007 ss HC 27 and HC 28.

F Partnerships, Joint Ventures, and Other Entities

Partnerships are transparent for tax purposes,[63] though partnerships must file tax returns.[64] That is, they calculate their income as a single enterprise and then divide the income between the partners according to their respective shares. The partners add their partnership income to other income that they may have and pay tax according to their individual rates or at company rates if partners are companies.

Joint ventures are not obliged to file joint returns tax,[65] but may elect to do so, being treated for tax purposes as partners.[66]

The Income Tax Act 2007 includes rules that relate to other, less common, investment and trading vehicles. Examples include:

- Agents[67] (That is, not tax agents, but individuals or companies that carry on investment or business, or aspects of business, on behalf of others, especially non-residents.)
- Mutual associations,[68] such as groups of tradespeople who combine together to purchase their trading stock.
- Maori authorities.[69] Maori are the native people of New Zealand. Some Maori investment or trading organisations are based on tribal or similar links and operate a little differently from, say, companies. They therefore require tailored rules for tax matters.
- Portfolio investment entities.[70] New Zealand offers few tax preferences. One is in respect of saving by investment, which can attract lower rates of tax. Portfolio investment entities are vehicles for such investments.

VI THE INTERNATIONAL DIMENSION

A Introduction

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63 Income Tax Act 2007 s HG 2.

64 Tax Administration Act 1994 s 42(3).

65 Tax Administration Act 1994 s 42(4).

66 Income Tax Act 2007 s YA 1, definition of "partner".

67 Income Tax Act 2007 subpart HD.

68 Income Tax Act 2007 subpart HE.

69 Income Tax Act 2007 subpart HF.

70 Income Tax Act 2007 subpart HM.

The Income Tax Act 2007 contains a full suite of the kinds of regimes that relate to trans-national trade and investment that have become common in developed economies since about 1980. On international matters, the Act starts by limiting its reach to income that has its source in New Zealand or that is derived by residents of New Zealand. The rules that achieve this result approach their outcome backwards. That is, Parliament drafted the Act to catch all income from every source derived by everyone, residents or non-residents. The Act then carves out foreign sourced income derived by non-residents by providing that it is not included in assessable income.[71] Chapter VI F below describes a notable exception, where certain foreign-sourced income derived by foreign-resident trustees is nevertheless taxable in New Zealand.[72]

B Standard Provisions

A good many provisions that relate to trans-national tax issues are more or less what one would expect, and mitigate what would otherwise be a harsh effect. For instance, New Zealand gives a credit to resident taxpayers in respect of source-country tax on inward-flowing income.[73] Another example relates to foreign residents who visit New Zealand for a short time and who during that time earn wages by working for their foreign employer. In principle, even though both employer and employee are non-resident the wages are taxable because, being earned in New Zealand, they have a New Zealand source. However, in most circumstances if the employee is present in New Zealand for fewer than 93 days the wages are exempt.[74]

This paper attempts only a sketch of the New Zealand international tax regime, but mentions several provisions of special interest.

C Categories of Outward-flowing Income

The Income Tax Act 2007 contains rules for exacting tax on business income derived by non-residents, with special rules for difficult cases, such as shipping profits. Generally speaking, there is no tax on business income of non-residents unless there is a "fixed establishment". The concept of fixed establishment is a concept of New Zealand law. It is similar in form and purpose to the familiar permanent establishment of double tax treaties, but is in general more all-embracing.

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71 Income Tax Act 2007 s BD 1(5).

72 Income Tax Act 2007 s BD 1(5)(c).

73 Income Tax Act 2007 subparts LF and LJ.

74 Income Tax Act 2007 s CW 19(1).

There are withholding taxes on passive income with rules and exceptions that are designed to frustrate avoidance. By way of example, the Act's definition of "royalty" is very extensive and turns more on substance than on form. The definition lists all kinds of payment that could possibly pass as a royalty or serve as a substitute for a royalty,[75] and adds:[76]

> For the purposes of [the list of the definitions of "royalty"], none of the following is relevant:
>
> (a) how the payment is described or computed:
>
> (b) whether the payment is periodical or otherwise:
>
> (c) whether the payment is an instalment of the purchase price of real property:
>
> (d) whether the payment is an instalment of the purchase price of personal property.

Readers familiar with international tax planning will appreciate that provisions like "how the payment is described or computed", "whether the payment is periodical or otherwise", and "whether the payment is an instalment of the purchase price of personal property" are calculated to prevent foreign taxpayers from shifting value from one part of a contract or other arrangement with a New Zealand counterparty to another, in order to re-characterise value that is in substance a royalty as something else, such as a "price".

An unusual feature of New Zealand international tax law is the "approved issuer levy". The levy replaces non-resident withholding tax on outward-flowing interest[77] with a levy on New Zealand-resident borrowers of two cents per dollar of interest paid to foreign lenders.[78] The reason for the approved issuer levy is to reduce the cost of capital borne by New Zealand businesses. When New Zealand borrowers must withhold tax on interest paid to foreign lenders the lenders customarily require the borrowers to gross up the interest so that the lenders receive the same net interest as in their original loan offer. This practice defeats the purpose of charging foreign lenders tax on interest that they earn from New Zealand. Various anti-avoidance rules try to protect the approved issuer regime from exploitation. For instance, approved issuer status is not available to a borrower where the foreign lender is an associated person. Among other things, this rule prevents New Zealand

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75 Income Tax Act 2007 s CC 9(2).

76 Income Tax Act 2007 s CC 9(3).

77 Income Tax Act 2007 s RF 12.

78 Stamp and Cheque Duties Act 1971 s 86H and s 86I.

borrowers from contriving lightly-taxed (that is, levy only) deductions for interest payments to associated foreign trusts or companies that the New Zealand borrower puts in funds.

From May 2012 there has been provision for the approved issuer levy to be reduced to zero in respect of certain issues of bonds denominated in New Zealand currency. In addition to the registration and reporting requirements that apply to any approved issuer borrowing, the bonds must be publicly traded or otherwise widely held. Other requirements further protect this rule against exploitation.[79]

Finally on passive income, there are provisions in respect of dividends passing between New Zealand and foreign companies, whether in the same group or not. Fitting these rules into the New Zealand imputation system for company taxation, described in chapter B, presents severe challenges to the statutory drafter; to explain the rules would unduly extend this paper.

D Specific Anti-avoidance Regimes

Since the mid-1980s, Parliament has progressively added anti-avoidance regimes to the international rules of the Income Tax Act, and from time to time strengthened those regimes. The regimes now include rules that address:

- Transfer pricing;
- Inbound thin capitalisation;
- Outbound thin capitalisation;
- Thin capitalisation of foreign-owned banks;
- Controlled foreign companies; and
- Foreign investment funds.

E Double Taxation Agreements

The Income Tax Act 2007[80] authorises the government of New Zealand to negotiate and to conclude agreements to provide relief from double taxation, to prevent fiscal evasion, to facilitate the exchange of information, and to assist in the recovery of unpaid tax. Historically, these last three purposes have been less significant than the first, but they are becoming progressively more prominent.

Double tax agreements enter into force when specified by an Order in Council made by the Governor-General.[81] They override the Income Tax Act in most

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79 Stamp and Cheque Duties Act 1971 s 86IB.

80 Income Tax Act 2007 subpart BH.

81 Income Tax Act 2007 s BH 1(3).

respects.[82] Orders in Council are a species of delegated legislation. Although formally promulgated by the Governor-General they are in fact decisions of the government, in effect the cabinet.

New Zealand has a continuous programme of negotiating and signing double taxation agreements. As at March 2015 there were 39 in effect. New Zealand follows the OECD Model Tax Convention, opting for credit rather than exemption, and ordinarily modifying OECD provisions in order better to reflect the country's status as a capital-importing nation. Surprisingly, New Zealand has not generally stipulated for a limitation of benefits clause, though, consistently with American double tax agreement policy, there is such a clause in the agreement with the United States of America.[83]

New Zealand's double tax agreements broadly speaking follow the approach of the Income Tax Act, but treat residents of treaty partner states more generously than does the statute. For instance, double tax agreements generally extend the 92 days of presence rule for foreign employees mentioned above[84] to 180 days.

F Trusts

As mentioned, trusts can be very useful vehicles for tax minimisation.[85] This potential of trusts is particularly marked when one adds an international dimension. Without special legislation, New Zealand residents could avoid tax simply by purchasing investments that produce foreign-source income and then transferring such investments to foreign trustees. The Income Tax Act 2007 contains a number of provisions that frustrate that and similar plans.

First, subject to certain exceptions, foreign-source income derived by a trustee, even if non-resident, is taxable if a settlor of the trust is resident in New Zealand.[86] If the foreign resident trustee fails to pay the tax the settlor must do so.[87]

Secondly, there is the question of trusts that immigrants settle offshore before they arrive in New Zealand. After settlors become resident in New Zealand the income of the trust becomes taxable by virtue of the rules just mentioned, but this

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82 Income Tax Act 2007 s BH 1(4).

83 New Zealand–United States Double Taxation Agreement 1983, as amended by protocol dated 2009, in effect from 2010, Article 16.

84 Chapter VI B.

85 Above, chapter V D.

86 Income Tax Act 2007 s HC 25(2).

87 Income Tax Act 2007 s HC 29(2).

tax may not be able to be enforced. To make up for this gap, if there are distributions to beneficiaries resident in New Zealand the distributions are taxable,[88] even though such a distribution would not normally be classified as beneficiary income. Some such distributions are taxed at a penal rate.[89]

Thirdly, there are rules to catch New Zealand-resident beneficiaries who become non-resident for a time and who receive trust distributions during that time that would have been liable to tax had the beneficiary remained resident in New Zealand. In these circumstances, beneficiaries become liable to the tax in question on their return if they become resident again within five years of becoming non-resident.[90]

G New Zealand Off-shore Trust Industry

A standard practice among common law jurisdictions that are not tax havens is to levy tax the income of trustees who are resident in the jurisdiction even if settlor, beneficiaries, and the income itself are all foreign. In contrast, New Zealand takes a substantive, economics-based approach. Where the only connection with New Zealand is a New Zealand-resident trustee, New Zealand takes the view that it is not appropriate to tax income derived from abroad. From an economic, though not from a legal, point of view trustees act very much as agents rather than as principals. Such income is therefore exempt, though there are certain disclosure and record-keeping requirements.[91]

This exemption, which has been in force since 1988, has led to a thriving offshore trust industry in New Zealand, though that was certainly not the objective of the policy makers at the time.[92]

VII AVOIDANCE AND THE GENERAL ANTI-AVOIDANCE RULE

A Avoidance and the Rule

As has been explained, many of the provisions in the Income Tax Act 2007 may be thought of as specific anti-avoidance rules, either plugging gaps in the somewhat crude concept of income that is, as it were, at the base of New Zealand's and most common law income tax systems, or frustrating attempts to exploit

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88 Income Tax Act 2007 s HC 15 and s HC 16.

89 Income Tax Act 2007 s HC 34.

90 Income Tax Act 2007 s HC 23.

91 Income Tax Act 2007 s HC 26.

92 Author's personal knowledge, as a member of government advisory committees that worked on the question.

mitigating rules that Parliament has inserted to soften the native harshness of an unrefined income tax.[93] Despite these many rules New Zealand suffers from tax avoidance just as do other jurisdictions, though unlike other jurisdictions New Zealand's income tax law has included a general anti-avoidance rule since income tax's first enactment in the Land and Income Assessment Act 1891.

The architecture of the Income Tax Act 2007 causes the general anti-avoidance rule to be spread over several sections, but it remains a recognisable successor of the original. The general anti-avoidance rule is often named after its acronym, the "GAAR". The core parts of the current rule read as follows:

> **BG 1 Tax avoidance**
>
> Avoidance arrangement void
>
> (1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.
>
> Reconstruction
>
> (2) Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement.
>
> **GA 1 Commissioner's power to adjust**
> [Section GA 1 empowers the Commissioner to reconstruct an arrangement that is found to be void under section BG 1 and to levy tax on the basis of the adjusted arrangement]
>
> **YA 1 Definitions**
> In this Act, unless the context requires otherwise,—
>
> **arrangement** means an agreement, contract, plan, or understanding, whether enforceable or unenforceable, including all steps and transactions by which it is carried into effect.
>
> **tax avoidance** includes—
>
> (a) directly or indirectly altering the incidence of any income tax:
>
> (b) directly or indirectly relieving a person from liability to pay income tax or from a potential or prospective liability to future income tax:
>
> (c) directly or indirectly avoiding, postponing, or reducing any liability to income tax or any potential or prospective liability to future income tax

93 Above, chapters IV C and IV D.

> **tax avoidance arrangement** means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly—
>
> (a) has tax avoidance as its purpose or effect; or
>
> (b) has tax avoidance as 1 of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the tax avoidance purpose or effect is not merely incidental.

In short, the rule provides that arrangements that have a purpose of tax avoidance are void against the Commissioner, who may reconstruct the arrangements in question and tax the taxpayers concerned pursuant to the reconstructed transactions.

B Interpretation and Application

The general anti-avoidance rule has always been controversial because it appears to breach the rule of law: for tax purposes, section BG 1 strikes down arrangements that are formally legally effective; it is not always easy to predict whether or how the section will operate.[94]

Over the years, courts have made many attempts to boil the section down to something that more resembles black letter law, with little eventual success. At a severe risk of over-generalization, the modern approach is what is known as the "Parliamentary contemplation" test, which comes from the case of *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* (2009). There, the Supreme Court said that the correct approach is to ask whether taxpayers have used provisions on which they rely:[95]

> [109] … in a manner that is consistent with Parliament's purpose. If that is so, the arrangement will not, by reason of that use, be a tax avoidance arrangement. If the use of the specific provision is beyond Parliamentary contemplation, its use in that way will result in the arrangement being a tax avoidance arrangement.

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94 See, eg, Rebecca Prebble and John Prebble "Does the Use of General Anti-Avoidance Rules to Combat Tax Avoidance Breach Principles of the Rule of Law? A Comparative Study' 55 St Louis University Law Journal (Symposium Issue, Sanford E. Sarasohn Memorial Conference on Critical Theory in Taxation) 21 – 45 (2011). Amplified version in Susy Frankel (ed) Learning from the Past, Adapting for the Future: Regulatory Reform in New Zealand (LexisNexis, Wellington, 2011).

95 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue (The Trinity Case)* [2009] 2 NZLR 289 [2008] NZSC 115 (SC) [108], [109] (SC) per McGrath J, judgment of the majority.

> [109] 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.
>
> [108] A classic indicator of a use that is outside Parliamentary intention is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way.

VIII CONCLUSION

Drafting effective tax legislation is a challenge for all jurisdictions. Everyone hopes that the result can be practical, simple, principled, and just, but at least as far as simplicity is concerned, this hope is a pipe dream. The best that can be done is to try to eliminate preferences that distort taxation, aiming for a tax that has as broad a base as possible, imposed at the lowest rate that will achieve the fiscal goals of the government. The New Zealand tax system is far from perfect, but it comes closer to the principles of good tax design than do many systems.