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**QWBA: Income Tax – Scenarios on Tax Avoidance – 2015 (PUB00236)**

**Introduction**

1. The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the *draft QWBA Income Tax – Scenarios on Tax Avoidance – 2015* (QWBA). The Law Society encourages the regular publication of examples illustrating the Commissioner's approach to the interpretation and application of the general anti-avoidance provisions to different types of arrangements. Given the degree of uncertainty associated with section BG 1, and the severe consequences for taxpayers who are party to arrangements that are subject to its application, such publications provide useful guidance for taxpayers and their advisers.

2. The Law Society's submissions relate to scenarios 2 and 3 of the QWBA.

**Scenario 2 – interest deductions and use of a portfolio investment entity**

*Overview*

3. The Law Society submits that both the fact description and the analysis of this scenario require clarification in order to provide an accurate description of how section BG 1 could potentially apply to an arrangement involving borrowing by a taxpayer to invest in a "cash portfolio investment entity (PIE)". Otherwise the reasoning in the QWBA on this example could equally be applied to numerous other situations where a taxpayer borrows money to make an investment. If left in its current form, this scenario calls into question whether the Commissioner considers that those other arrangements are also subject to section BG 1.

*Arrangement description*

4. The arrangement description in paragraph 32 of the QWBA is that the taxpayer borrows from Bank A to invest in a PIE that has as its only assets deposits with Bank A, in circumstances where the relevant interest rates and tax rates are such that the taxpayer derives a negative net return on a pre-tax basis but a positive net return once the tax consequences are taken into account.

5. Without more, the Law Society does not agree that section BG 1 would apply to that arrangement description. In particular, the Law Society submits that certain statements in the discussion section of Scenario 2 supporting the conclusion that section BG 1 applies (for example, at paragraph 56 that "there is no underlying investment in a commercially and economically realistic sense") could only be maintained if additional features were present in the arrangement description.

6. The Law Society submits that the arrangement description in paragraph 32 should therefore be amended to state that:

   - the (fixed) term of the loan to the taxpayer is the same as the (fixed) term of the taxpayer's investment in the PIE; and
   - the terms of the loan between the Bank and the taxpayer include that the loan proceeds may only be used to acquire units in the PIE and the loan is limited recourse to those units.

7. These additional features would make clear that the arrangement is circular and "ring-fenced" in such a way that neither the taxpayer nor Bank A is subject to any real financial risk as a result of entering into it. Further, in the Law Society's view, the presence of such features would provide a basis for the statements regarding there being "no investment or savings activity involved in the arrangement as a matter of commercial and economic reality" (paragraph 51) and "no underlying investment in a commercially and economically realistic sense" (paragraph 56).

*Commissioner's reasoning*

8. A significant component of the Commissioner's reasoning appears to be that the arrangement produces a negative return on a pre-tax basis, and the positive after-tax return would not have resulted if the taxpayer had invested directly (i.e. invested in a bank deposit paying 4.9% that is subject to tax at 33%) rather than investing in a PIE. However, the reasoning does not mention that Parliament clearly contemplated investments made through a PIE being subject to tax at a maximum final rate of 28%.

9. Taxpayers will naturally have regard to the tax consequences of an investment when considering whether to make it. That is because investment decisions are properly made based on an investment's after-tax return, not its pre-tax return. The fact that the relevant tax rules make the difference between the net return being negative and positive, or enhance the after-tax return, does not mean that section BG 1 applies. The question in terms of section BG 1 (as articulated by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115) is whether the arrangement (when viewed in a commercially and economically realistic way) makes use of the specific provisions in a manner consistent with Parliament's purpose for those provisions. The question is not whether the arrangement would have occurred on the terms which it did in the absence of those provisions.

10. Accordingly, in the Law Society's view, an arrangement involving an investment in a PIE that produces a positive net return only once the difference between the 28% PIE tax rate and the taxpayer's 33% marginal tax rate (at which interest deductions are claimed) is taken into account will not, without more, attract the application of section BG 1. There are numerous

examples of investments that are made only because (for example) the expected return is made up of both (untaxed) capital gain and taxable income or because the amount of income that is taxed differs from the actual return (for example, foreign shares taxed under the FDR method).

11. The Law Society therefore submits that:

(a) It is misleading to suggest Parliament would contemplate that "the investor's economic return is the same as if they had invested directly in similar investments to those made by the PIE" (paragraph 46, 8th bullet point) without qualifying that statement by reference to the existence of the 28% maximum rate of PIEs.

(b) As regards the two other factors that the QWBA says Parliament would contemplate in Scenario 2, but that are not present,[1] the QWBA should make it clear that these factors do not mean that the arrangement must generate a pre-tax positive return. Rather, the QWBA should state that what is required is that the arrangement involves a real change in the parties' financial circumstances consistent with what would be expected for a leveraged investment of this nature. The Law Society suggests that the factors themselves are reworded to make that clear.

*Confusing terminology*

12. Finally, the Law Society submits that some of the terminology used in the discussion of Scenario 2 could be improved. For example, the first sentence of paragraph 51 would make better sense if the term "actual savings" was replaced with "positive net return". Similarly, in the third sentence of that paragraph, "real savings" could be replaced by "income" and "the borrowing" could be replaced by "interest on the borrowing". Otherwise the references appear to confuse principal amounts with income or expense amounts.

**Scenario 3: use of discretionary trust**

13. The Law Society generally agrees with the analysis and conclusion in this Scenario. However, it would be useful if the QWBA elaborated on the factual variations referred to in paragraph 90 that the Commissioner considers may result in section BG 1 applying, perhaps by way of example. The Law Society finds it difficult to envisage a scenario where a distribution has properly been made to a beneficiary in accordance with the terms of the trust, and would be recognised at law as such, but where it could be said in commercial and economic reality a distribution has not been made.

[1] That is, (at paragraph 46, 7th and 9th bullet points):

- The involvement of the PIE is furthering the taxpayer's savings and investment activities.
- The borrowed funds generate income in a commercially and economically realistic sense for the borrower.

14. For example, a factor referred to in paragraph 91 is the timing and pattern of the addition and removal of beneficiaries. However, if a new beneficiary is validly appointed, a distribution is validly made to that beneficiary, and then the beneficiary is validly removed as a beneficiary, it is difficult to see how, in commercial and economic reality, a distribution of income is not made to a beneficiary of the trust. The status as a beneficiary is generally relevant only at the time a distribution is made.

**Conclusion**

15. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss further, please do not hesitate to contact the committee's convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours sincerely

Mark Wilton
**Vice-President**