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WEEKLY COMMENT: FRIDAY 19 JUNE 2015

1. On 11 June Inland Revenue released an Exposure Draft of Question We've Been Asked PUB00236: *Income tax – Scenarios on tax avoidance* ("the draft QWBA") with a deadline for comments of 23 July. This week I look at the draft QWBA.

2. Three scenarios are covered:

   (a) The use of a limited partnership in a way that allows the continued use of tax losses;

   (b) The use of a portfolio investment entity ("PIE") to invest wholly borrowed funds; and

   (c) The use of a discretionary trust to provide beneficiary income to beneficiaries with tax benefits.

3. The discussion and conclusions in the draft QWBA are caveated as follows:

   (a) First, the conclusions reached are limited to the arrangements set out;

   (b) Second, the analysis proceeds on the basis that the tax effects under the specific provisions of the Act are achieved as stated; and

   (c) Third, the implications of any specific anti-avoidance provisions are not considered.

4. Also noted is that if voiding an arrangement does not appropriately counteract the tax advantages, the Commissioner is required to apply s. GA 1 to ensure this outcome is achieved.

Use of a limited partnership

5. In this scenario:

   (a) Company A, a company with available tax losses (having met the 49% minimum shareholding continuity requirement for carrying forward and using the tax losses) has a wholly owned subsidiary, Profit Co that owns a profitable business.

   (b) Company A and Profit Co meet the 66% commonality of shareholding grouping rules so as to allow Company A's tax losses to be grouped with Profit Co's business profits.

   (c) Company A forms a new limited partnership with an unrelated third party, Company B, in which contributions and partnership profits and losses are to be shared equally.

   (d) Company A causes its subsidiary Profit Co to sell its entire profitable business to the limited partnership for the open market value.

   (e) The partnership begins operating the business and derives the profits, which are shared equally between Companies A and B.

(f) Company A uses its available tax losses to eliminate taxable income on its share of the business profits from the limited partnership.

6. The discussion proceeds on the basis that the objective of the arrangement is for Company B, an unrelated third party, to take a financial interest in the business of Profit Co. Given that, the Parliamentary contemplation test is met, for the following reasons.

7. The legal form of the arrangement is that:

   (a) A limited partnership, under the *Limited Partnerships Act 2008*, has been formed by unrelated investors to co-invest in a profitable business;

   (b) The limited partnership acquired the business of Profit Co for its market value; and

   (c) The partnership tax rules together with the rules that allow tax losses to be carried forward and used mean that Company A is able to use its tax losses to reduce or eliminate its taxable income from its share of the limited partnership.

8. In the Commissioner's opinion, the commercial and economic reality of the arrangement mirrors its legal form:

   (a) A third party, Company B, has made an arm's length investment through a limited partnership, consistent with Parliament's purposes that limited partnerships are used as investment vehicles;

   (b) Company A loses half of the profitable business of its wholly owned subsidiary in the process;

   (c) Company A has met the shareholding continuity rules for carrying forward and using tax losses, therefore the arrangement does not defeat Parliament's expectation that the group of persons who bore the economic loss enjoy the benefit of those losses being offset against future income.

9. An alternative arrangement is considered that could potentially achieve the same results with different tax effects. If Company B had acquired half of the shares in Profit Co instead of acquiring 50% of Profit Co's business through the limited partnership, arguably the same investment result would have been obtained, but Company A would not have been able to continue to group its tax losses with Profit Co. Therefore, its tax losses could no longer be used to reduce or eliminate Profit Co's business profits.

10. It is stated that applying the Parliamentary contemplation test does not involve identifying an arrangement, or one of several arrangements, that is economically equivalent to the arrangement entered into (i.e. an "economic equivalence" approach is not espoused. Only the commercial and economic reality of the arrangement actually entered into needs to be looked into. This is consistent with what the Commissioner has stated in paragraph [377] of IS 13/01 on *Tax Avoidance*. It is also noted that:

    "In addition the Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115 (at [111]) considered that taxpayers have the freedom to structure transactions to their best tax advantage. The court considered taxpayers may utilise available tax incentives in whatever way the applicable legislative text, read in light of its context and purpose, permits. Accordingly, there is no general requirement for the parties in this scenario to adopt an alternative, less tax-favourable, arrangement. What they cannot do, however, is adopt an arrangement in a way that is proscribed by the general anti-avoidance provision. That is, taxpayers have freedom to choose how they structure their arrangements, provided they

make use of the provisions of the Act in a way intended by Parliament (see also *Penny v CIR* [2011] NZSC 95 at [49]).”

11. One feature in this scenario is that:

    “A minimum of 66% commonality of shareholding between the group of persons holding voting interests in Company A and Profit Co from the time Company A incurred the tax losses until the end of any year in which they are offset against any future income of Profit Co.”

12. In other words, if the limited partnership arrangement had not been entered into, Company A should have been able to continue grouping its tax losses with the business profits of Profit Co. The implication is that the limited partnership arrangement should not have been entered into in order for Company A to use its tax losses against Profit Co’s business profits in circumstances where it may no longer have been able to group its tax losses with profit Co’s income. The arrangement permits the continuation of a tax benefit that already exists, albeit in a different form.

Use of a portfolio investment entity

13. The second scenario concerns the use of a multi-rate PIE to invest borrowed funds. A key advantage in using a multi-rate PIE as an investment vehicle is that the maximum tax rate is 28%. The scenario involves an investor on the top marginal rate of 33% borrowing from a bank, at interest, in order to invest in a multi-rate PIE operated by the same bank.

14. The arrangement is described as being “pre-tax negative”. This is because the interest rate charged by the bank is 5% per annum, whereas the interest rate received from the PIE is 4.9%. In the absence of any tax effects, the investor would suffer a loss of 0.1% on the investment.

15. However, the arrangement is “post-tax positive” in the sense that the investor is allowed a tax deduction for the 5% per annum interest payable to the bank with a tax effect of 33% at the top marginal rate, whereas the interest income of 4.9% is only taxed at 28%. The tax effects turn the pre-tax loss of 0.1% into a post-tax profit of 0.178%.

16. In the Commissioner’s view this arrangement is tax avoidance. The reasons advanced are as follows:

    (a) Parliament’s objectives in enacting the PIE rules were to promote savings and investment by:

        (i) Allowing individual investors to invest through collective investment vehicles with tax effects equal to those if the investors had directly invested themselves; and

        (ii) To limit the top tax rate to a “prescribed investor rate” or PIR of 28% within the PIE and treat the after-tax income from the PIE as excluded income so as to allow tax deductions to be claimed against such income in the same way as if the investments had been made directly.

    (b) In these circumstances, the involvement of the PIE is not part of furthering the taxpayer’s savings and investment activities: the borrowing is an integral part of the arrangement, and the taxpayer is not contributing any of their own capital.

    (c) The actual savings achieved by the taxpayer are solely the result of the arrangement’s tax benefits, and there is no actual investment involved.

    (d) The Parliamentary contemplation test is not met because:

(i) There is no generation of income in a real sense from the borrowing and no equivalence from the income generated through the PIE and the income that would be generated through a direct investment;

(ii) While the advantage of a 28% top PIR in a PIE is within Parliamentary contemplation (reference is made to Example 2 in IS 13/01 at 98-101 of a taxpayer on the top marginal rate who withdrew a non-PIE investment to invest in a PIE and there being no tax avoidance in that situation), in this case there is no underlying investment in a commercially and economically realistic sense;

(iii) There is a circular movement of funds from the bank to the investor and back to the bank, and is stated that "the circular movement of money in an arrangement is often an indicator of tax avoidance, as it can lead to the effective neutralisation or distortion of economic outcomes".

17. The tax avoidance purpose or effect is not merely incidental to a non-tax avoidance purpose or effect because:

(a) While it could be argued that the purposes or effects of the arrangement could be seen as being concerned with the generation of investment income, general purposes that can potentially be achieved in several different ways will not explain the particular structure or arrangement; and

(b) The only purpose or effect of the arrangement in this case is to generate a return from the tax system.

18. The suggested method for voiding the arrangement as against the Commissioner is a reconstruction so to limit the taxpayer's interest deductions so that the tax benefit at the 33% marginal rate matches the tax already paid by the PIE at the 28% PIR. In comparison, voiding the whole arrangement would have a tax impact on the PIE, which is not seen as appropriate in the circumstances.

Use of a discretionary trust

19. This scenario concerns the distribution of beneficiary income by a discretionary trust. The trustees have the discretion as to whether to distribute income and what income to distribute, and they also have the discretion to choose which beneficiaries are to receive distributions from the trust. Beneficiary income is distributed to the following beneficiaries, all of whom are existing beneficiaries of the trust and New Zealand tax residents:

(a) An adult beneficiary who is taxed at the lowest marginal rate;

(b) A solvent corporate beneficiary with available tax losses equal to or greater than the beneficiary income; and

(c) A corporate beneficiary, where the beneficiary income consists of foreign dividends exempt from tax under s. CW 9.

20. In the Commissioner's view, if these particular circumstances are met, the arrangement would not constitute tax avoidance. It is accepted that the beneficiary's tax position is taken into account when paying beneficiary income.

21. Moreover, the income need not be physically distributed. A declaration or resolution by a trustee coupled with the amount being credited to the beneficiary or dealt with in the beneficiary's interest or on their behalf in some other way will be sufficient. The case law

supporting this is discussed in IS 12/02 "Income tax – Whether income deemed to arise under tax law, but not trust law can give rise to beneficiary income", published in *Tax Information Bulletin* Vol. 24, No. 7, August 2012, and is also discussed in the explanation of the trust tax regime in the Appendix to *Tax Information Bulletin* Vo. 1, No. 5, November 1989.

22. The key issues in this scenario are that:

    (a) Apart from very specific limitations, like the rule in s. LE 5 preventing the streaming of imputation credits to particular beneficiaries, and the rule in s. HC 35 preventing distributions exceeding $1,000 to minor beneficiaries, Parliament has generally left it to trust law to determine which beneficiaries receive distributions of beneficiary income, and how much they receive.

    (b) Trust law allows trustees to prefer some beneficiaries over others – the House of Lords decision in *Gartside v IRC* [1967] UKHL 6, [1968] 1 All ER 121 is authority for the view that beneficiaries of a discretionary trust have no proprietary interest in the trust property, and only have a right to be considered for nomination as a beneficiary.

    (c) Neither the general trust law nor the Income Tax Act 2007 prevents trustees of a discretionary trust taking into account the tax consequences arising for a beneficiary, and s. HC 22 contemplates that a beneficiary who receives a distribution from a non-complying trust may have tax losses available.

    (d) The beneficiaries receiving distributions of beneficiary income are eligible to benefit under the trust – i.e. they are in reality, beneficiaries of the trust.

23. When the Parliamentary contemplation test is applied to the above, the facts, features and attributes Parliament would expect are present as matters of commercial and economic reality. Although the trustees' choices were significantly influenced by tax considerations, the *Ben Nevis* decision (see paragraph 10 above) allows taxpayers to structure arrangements to their best tax advantage, provided the use of the provisions is within what Parliament would have contemplated.

24. The discussion on this scenario concludes by considering factual variations that could amount to tax avoidance. It is noted that, for example, it could be argued that no distribution of income to a beneficiary was made from a commercial or economic perspective because:

    (a) The beneficiary was not a beneficiary of the trust; or

    (b) No distribution of income was made to the beneficiary.

25. Apparently this may be able to be discerned from:

    (a) The timing and pattern of the addition and removal of beneficiaries;

    (b) How and when income was distributed, including terms of the trustees' resolution, and any payments, journal entries or other means of distribution;

    (c) Any facts indicating whether the trustees, or other parties other than the nominated beneficiaries, retain the use and benefit of the income; and

    (d) Other facts indicating whether the trustees or parties other than the nominated beneficiaries retain the use and benefit of the income.

26. A qualification is added that on their own there may be nothing inherently wrong with these factors (for example, paying distributions by journal entry) but in combination they may raise doubts as to whether a distribution was made.

27. Also mentioned in general terms is the possibility of other arrangements involving more complexity constituting tax avoidance. However, the approach to applying the general anti-avoidance rule remains the same:

    (a) The approach commences with discerning Parliament's purposes for the relevant provision or provisions of the Act;

    (b) It then requires determining the facts, features and attributes Parliament would expect to be present (or absent: and

    (c) Finally, the arrangement is examined and a decision is reached on whether the requisite facts, features and attributes are present as matters of commercial and economic reality and, if not, whether the tax avoidance purpose is merely incidental to a non-tax avoidance purpose or effect of the arrangement.

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