Inland Revenue
Te Tari Taake

CASE SUMMARY

Court of Appeal finds tax avoidance, but no shortfall penalties for taking an unacceptable tax position

Decision date: 03 September 2020

CSUM 20/11

CASE

Commissioner of Inland Revenue v Frucor Suntory New Zealand Limited [2020] NZCA 383.

LEGISLATIVE REFERENCES

Income Tax Act 2004, ss BG 1, DB 7, EH 48(3)(a), subpart EW, GB 1, OB 1, OB 6.

Tax Administration Act 1994, ss 108, 141B, 141D, 141FB.

LEGAL TERMS

Tax avoidance, tax advantage, shortfall penalties, unacceptable tax position.

Summary

The Commissioner of Inland Revenue ("Commissioner") sought to disallow interest deductions claimed by Frucor Suntory New Zealand Limited ("Frucor") in respect of a tax-driven structured finance transaction it entered in to in March 2003 with the Deutsche Bank. The Commissioner contended that the funding arrangement was a tax avoidance arrangement in terms of s BG 1 of the (now repealed) Income Tax Act 2004 and denied a portion of Frucor's claims for deductions in the 2006 and 2007 income tax years. She also contended that Frucor took an unacceptable tax position and shortfall penalties should be imposed.

Frucor had been successful in the High Court, with that Court holding that the funding arrangement was not a tax avoidance arrangement; the Commissioner's assessments for 2006 and 2007 were incorrect and were thereby cancelled; and Frucor did not take an unacceptable tax position (and so the Court would have set aside the shortfall penalties imposed of $1,786,555 and $1,924,779 even if it had been wrong on its principal conclusion).

The Commissioner appealed and the Court of Appeal allowed the appeal, set aside the orders of the High Court, reinstated the Commissioner's assessments with regards to the disallowed deductions and held that shortfall penalties did not apply.

Impact

The decision confirmed that the prohibition on identification of an economically equivalent arrangement that would not have constituted tax avoidance does not preclude consideration of the economic and commercial effect of the transaction under scrutiny. Such consideration, focusing entirely on the funding arrangement in question, was central to the second stage of the *Ben Nevis* analysis. The artificial and contrived features of the funding arrangement revealed the purpose of the arrangement was to dress up a subscription for equity as an interest only loan to achieve a tax advantage.

The decision also confirmed that where an arrangement is deemed void in accordance with s BG1 of the Tax Administration Act 1994, the taxpayer's deductions and assessable income may be adjusted by the Commissioner by application of s GB 1, as she thinks appropriate to counteract any tax advantage obtained by the taxpayer from or under the arrangement. The tax advantage with which the section is concerned is the New Zealand tax advantage achieved by the New Zealand taxpayer and the Commissioner is not required to consider other arrangements the taxpayer might have entered into had it not chosen to proceed with the tax avoidance arrangement under review. Thus, the Commissioner may reconstruct by allowing a portion of a deduction and disallowing the balance.

The Court of Appeal accepted the High Court's expression of the test for whether a taxpayer takes "an unacceptable tax position" under s 141B, as "whether there is substantial merit in the taxpayer's arguments." Although it came to different conclusion on the core tax avoidance issue, it was not persuaded that Frucor's arguments could be dismissed as lacking substantial merit, and this was particularly so where a lower court Judge explained in a careful, closely reasoned and comprehensive judgment why he was persuaded those arguments were factually and legally correct.

Facts

Frucor entered into a funding arrangement, whereby Deutsche Bank advanced $204m to Frucor in exchange for a fee of $1.8 million and a convertible note redeemable at maturity in five years' time by the issue of 1,025 non-voting shares in Frucor (the "note"). The $204m advance by Deutsche Bank was funded by a contemporaneous payment of $149m from Frucor's parent Danone Asia Pty Ltd ("DAP") for the forward purchase of the shares from Deutsche Bank in five years' time at a pre-agreed price matching the face value of the note (the forward purchase agreement). The balance of $55m was contributed by Deutsche Bank.

Over the life of the note, Frucor paid $66m to Deutsche Bank and claimed the full $66m as interest payments on an interest only basis on $204m. The $66m coupon payments equated to the amount required to pay amortising principal and interest on the $55m introduced into the funding arrangement by Deutsche Bank.

Issues

The issues for consideration by the Court of Appeal were:

- Did the High Court err in finding the funding arrangement was not a tax avoidance arrangement under s BG 1 of the Income Tax Act 2004 (the "Act")?
- Did the Commissioner correctly counteract the tax advantage under s GB 1 of the Act? (Frucor argued there was no tax advantage even if this was a tax avoidance arrangement. Muir J in the High Court did not need to deal with this issue because of his principal finding. Frucor gave the Court of Appeal notice it supported the High Court judgment on this additional ground.)
- Did the High Court err in finding that shortfall penalties should not be imposed in any event?

Decision

Tax Avoidance

The Court of Appeal found that it was "reasonably plain" that the funding arrangement had New Zealand tax avoidance as one of its purposes or effects and this was not merely incidental to some other purpose. The primary purpose of the funding arrangement was to provide a tax advantage to Frucor through the interest deductions it claimed. The funding arrangement was in many respects artificial and clearly contrived. The Court of Appeal found that taking the parts of the arrangement together, the purpose of the arrangement was to "dress up a subscription for equity as an interest only loan to achieve a tax advantage."

Gilbert J concluded: "[i]t is hard to discern any rational commercial explanation for the artificial and contrived features of the arrangement, other than tax avoidance." *Commissioner of Inland Revenue v Frucor Suntory New Zealand Limited* [2020] NZCA 383.

As a matter of commercial and economic reality, the Court of Appeal found that the payment of $149m by DAP did not carry any interest liability for Frucor or Deutsche Bank. The only amount that did attract interest was the $55m advanced by Deutsche Bank under the note, for which Frucor paid $11m in deductible interest expenditure. Therefore, Frucor used the specific provisions to claim deductions for interest in an artificial and contrived manner that cannot have been within Parliament's contemplation.

The Court of Appeal held it was not relevant that Frucor could have borrowed the $204 million from another Danone entity at an arm's length rate of interest and be entitled to claim the same interest deductions. The focus must be on the arrangement that was entered into, not one that might have been entered in to but was not.

The Court of Appeal concluded that the prohibition on identification of an economically equivalent arrangement does not preclude consideration of the economic and commercial effect of the transaction under scrutiny. Such consideration, focusing entirely on the funding arrangement in question, is central to the second stage of the *Ben Nevis* analysis and it is by no means "almost meaningless" or a "mere checkpoint for the Commissioner to divert around" as the High Court Judge had suggested.

The Court of Appeal held:

> *We consider that when the economic and commercial effect of the funding arrangement is examined in its context, it becomes clear that tax avoidance was its principal purpose or effect or, at least, tax avoidance was not merely an incidental purpose or effect of the arrangement. In summary, we accept the Commissioner's submission that by entering into the funding arrangement Frucor achieved a $66 million interest deduction without incurring a corresponding economic cost for which Parliament intended deductions would be available. As a*

> *matter of commercial and economic reality, $55 million of the claimed interest represented the repayment of principal borrowed from Deutsche Bank and was not an interest cost. We have therefore concluded that the Commissioner was entitled to invoke s BG 1.*

Section GB 1

The Court of Appeal noted that the tax advantage with which s GB 1 is concerned is the New Zealand tax advantage achieved by the New Zealand taxpayer (here Frucor). The funding costs and tax position of other parties to the funding arrangement are irrelevant to the analysis under s GB 1.

The Court of Appeal held the tax advantage gained under the arrangement was not the entire interest deductions, but only those that were principal repayment of $55m. The Commissioner was therefore, entitled to reconstruct by allowing the permissible deductions totalling $11m but disallowing the balance. She was not required to consider other arrangements the taxpayer might have entered in to, had it not chosen this particular funding arrangement.

Shortfall Penalties

The Commissioner sought to impose shortfall penalties under s 141B of the Tax Administration Act for Frucor's taking of "an unacceptable tax position" that when viewed objectively, failed to meet the standard of being "about as likely as not to be correct". The Commissioner contended that Frucor had taken such a position because tax avoidance was the dominant purpose of the arrangement.

Frucor submitted that the question of whether a taxpayer's position was "about as likely as not to be correct" was correctly distilled by the High Court Judge to "whether there is substantial merit in [the taxpayer's] arguments". Expressed another way, Frucor submitted, the question is whether the taxpayer's argument would be seriously considered by a court.

Frucor submitted that the High Court judgment was a complete answer to any question of penalties.

Relying on the decision of Kós J in *Commissioner of Inland Revenue v John Curtis Developments Ltd*, *Commissioner of Inland Revenue v John Curtis Developments Ltd* [2014] NZHC 3034, (2014) 26 NZTC 21-113, Frucor submitted that its position must be regarded as one capable of being reasonably adopted and having substantial merit - given it was found to be correct by the High Court.

The CoA agreed with Frucor referencing the Supreme Court's stance in *Ben Nevis, Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 that the inclusion of the word "about" in the test shows that a 50 per cent prospect of success is not the standard; rather the question is whether the merits of the arguments supporting the taxpayer's interpretation are substantial.

The Court of Appeal held that although it came to a different conclusion from the High Court on the core tax avoidance issue, it was not persuaded that Frucor's arguments could be dismissed as lacking in substantial merit.

The Court of Appeal regarded the High Court judge, Muir J as an experienced commercial Judge who regarded Frucor's argument as deserving of serious consideration. The High Court judgment explained in a careful, closely reasoned and comprehensive way, the reasons why the Judge was persuaded Frucor's arguments were factually and legally correct.

The appeal was allowed, and the orders made in the High Court were set aside. The Court of Appeal ruled that the interest assessments were to be reinstated but the shortfall penalties the Commissioner had sought, do not apply.

About this document

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