IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

I TE KŌTI MATUA O AOTEAROA
TĀMAKI MAKAURAU ROHE

CIV-2012-404-0219
[2018] NZHC 2860

BETWEEN	FRUCOR SUNTORY NEW ZEALAND LIMITED Plaintiff
AND	COMMISSIONER OF INLAND REVENUE Defendant

Hearing:	2, 3, 4, 5, 9, 10 and 11 July 2018
Appearances:	L McKay, M McKay and J Q Wilson for the Plaintiff JBM Smith QC, J Norris, L K Worthing for the Defendant
Judgment:	5 November 2018

JUDGMENT OF MUIR J

This judgment was delivered by me on Monday 5 November 2018 at 2.30 pm
Pursuant to Rule 11.5 of the High Court Rules.

Registrar/Deputy Registrar

Date:…………………………

Solicitors:
Bell Gully, Auckland
Crown Law, Wellington

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Introduction

[1] This case concerns application of the much-litigated general anti-avoidance rule in s BG 1 of (relevantly) the Income Tax Act 2004 (the Act).

[2] In issue are deductions of $10,827,606 and $11,665,323 which were disallowed in the 2006 and 2007 income tax years respectively.[1] In addition, the Commissioner has imposed shortfall penalties of $1,786,555 and $1,924,779 for those years.[2] The outcome of the case also governs the taxpayer's liabilities in the 2008 and 2009 income tax years for which it has not claimed what would be broadly equivalent deductions but in respect of which it has issued notices of proposed adjustment seeking to do so.[3]

[3] The claimed deductions arise in the context of an arrangement (the Arrangement) entered into by Frucor Holdings Ltd (FHNZ) involving, among other steps, its issue of a Convertible Note (the Note) to Deutsche Bank, New Zealand Branch (DBNZ) and a forward purchase of the shares DBNZ could call for under the Note by FHNZ's Singapore based parent Danone Asia Pte Ltd (DAP).

[4] The Note had a face value of $204,421,565[4] and carried interest at a rate of 6.5 per cent per annum. Over its five-year life, FHNZ paid DBNZ approximately $66 million which FHNZ characterised as interest and deducted for income tax purposes. The Commissioner says that, although such deduction complied with the "black letter" of the Act, $55 million of the $66 million paid was in fact a non-deductible repayment of principal.[5] She has invoked s BG 1 to treat the $55 million as non-deductible, allowing an interest deduction of $11 million only over the life of the Arrangement.

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1 These figures represent the deduction disallowed by the Commissioner, as compared to the deductions claimed by the taxpayer: $13,250,998 in 2006 and $13,323,806 in 2007.

2 Based on an allegedly abusive tax position but mitigated by the taxpayer's prior compliance history.

3 In so doing, avoiding any exposure to shortfall penalties for the 2008 and 2009 years in the event it is unsuccessful in the present proceedings. The income years 2004 and 2005, in which interest deductions were also claimed under the relevant transaction are time barred.

4 Which I will refer to hereafter as $204 million without derogating from the Commissioner's argument that the precise amount of the Note is itself evidence of artifice in the transaction.

5 As the parties did in both the evidence and the argument, I use the $55 million figure for illustrative purposes. In fact, as recorded in fn 3 above, the Commissioner is time barred from reassessing two of FHNZ's relevant income tax returns.

The issues

[5] The primary issue in the proceedings is whether s BG 1 of the Act applies to the Arrangement.

[6] Two further issues arise if s BG 1 is held to apply:

(a) whether the Commissioner's reconstruction of the Arrangement pursuant to s GB 1 of the Act is correct or whether it is, as FHNZ submits, "incorrect and excessive"; and

(b) whether the shortfall penalties in ss 141B (unacceptable tax position) or 141D (abusive tax position) of the Tax Administration Act 1994 (TAA) have application.

The key parties

[7] The key parties to the Arrangement were FHNZ, DBNZ and DAP. In addition, several other entities had subordinate roles as I will discuss later.

[8] FHNZ is the successor company to Danone Holdings NZ Limited (DHNZ) which is the company named as issuer of the Note. On 30 January 2009, DHNZ changed its name to FHNZ and on 19 May 2009 amalgamated with the plaintiff (then named Frucor Beverages Limited).

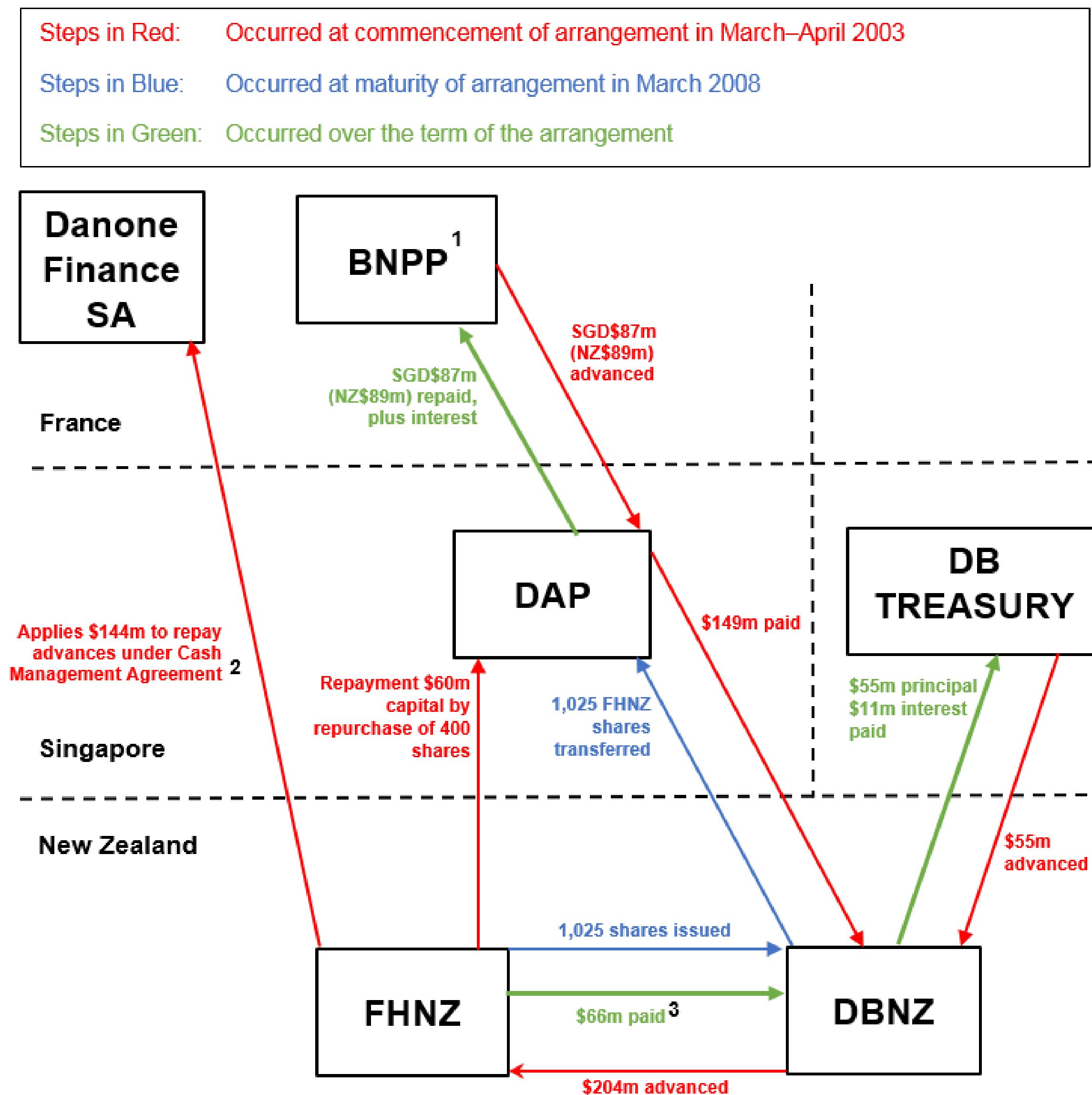
[9] For convenience, I intend to refer to FHNZ throughout as the party which issued the Note, made payments to DBNZ through the Note's life and which, in satisfaction of the relevant liability, issued shares to DBNZ at the conclusion of the Note's five-year term.

[10] During all periods relevant to the dispute FHNZ was wholly owned by DAP, itself part of the multinational Danone Group of which the ultimate parent is Groupe Danone SA, a French-based company. As indicated, DAP entered into a Forward Purchase Agreement with DBNZ.

[11] DBNZ is the New Zealand branch of Deutsche Bank AG a banking and financial services company based in Germany. DBNZ entered into the two primary transactions which feature in the dispute namely the Note (with FHNZ) and the Forward Purchase Agreement (with DAP).

Diagram of the key steps

[12] The key steps on entry into the Arrangement, the money flows which occurred during the life of the Arrangement and the steps taken at maturity are best represented diagrammatically:



1 BNP Paribas, an international banking group.
2 Full repayment effected by a paid 'top up' from FHNZ's own reserves.
3 Interest on FHNZ's characterisation $55m principal and $11m interest on the Commissioner's characterisation.

The Note and the Forward Purchase — Outline

The Note

[13] On 14 March 2003 FHNZ and DBNZ entered into a Convertible Note Deed whereby DBNZ agreed to pay FHNZ $204 million for issue by FHNZ of a Convertible Note.

[14] The key terms of the Deed were as follows:

(a) The Note was denominated in New Zealand dollars.[6]

(b) It matured on the fifth anniversary of the issue date (being 18 March 2008).[7]

(c) FHNZ paid interest at 6.5 per cent per annum in respect of the principal amount of the Convertible Note, payable semi-annually in arrears.[8]

(d) Redemption of the Note was governed by cls 5.1 and 5.2 in terms:

> **5.1 Redeemed for cash:** subject to clause 5.2 on the Maturity Date the Company shall satisfy the principal obligations of the Company in respect of the Note by paying to the Investor an amount equal to the Redemption Amount.
>
> **5.2 Conversion:** if, but only if, the Investor has given the Company written notice not less than 10 Business Days prior to the Maturity Date that it elects to have all the obligations of the Company in respect of the Principal Amount satisfied by the issue of the Shares then the Company shall issue to the Investor the Shares by not later than 4 pm (time being of the essence) on the Maturity Date and those obligations shall be satisfied in full by such issue.

(e) The option to convert to shares was not detachable from the Note.

(f) The Note did not confer on the holder any right to attend or vote at any meeting of FHNZ.[9]

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6 Clause 1.1.
7 Clause 1.1.
8 Clause 3.1 in the definitions of interest payment date, interest period and interest rate in cl 1.1.
9 Clause 2.3.

[15] FHNZ issued a Note Certificate with respect to the Note on 18 March 2003 (the issue date).

The Forward Purchase

[16] DAP entered the Forward Purchase with DBNZ on 14 March 2003 in respect of the shares that DBNZ would receive on maturity of the Note if it so elected. The key terms of the Forward Purchase Agreement were as follows:

(a) DAP agreed to pay $149 million to DBNZ on 18 March 2003.[10]

(b) DBNZ agreed that, if it elected to convert the Note and receive the shares, it would transfer those shares to DAP.[11]

(c) In the event DBNZ elected to convert but FHNZ failed to issue the shares (and instead repaid the principal in cash), DBNZ would pay such sum to Campagnie Gervais Danone (CGD) (another Danone Group company), with CGD assuming all of DBNZ's obligations under the Deed, including delivery of the Shares to DAP, as a novation counterparty.[12]

(d) In the event DBNZ did not elect to convert for shares, then it would pay to DAP the $204 million principal received from FHNZ together with an additional amount reflecting the tax imposed by Singapore on the difference between the $149 million paid under the Forward Purchase Agreement and the $204 million received.[13]

[17] The Commissioner's expert, Professor Lewis Evans calculated such potential Singaporean tax liability as $13.9 million. This was not disputed by FHNZ, nor did it dispute that in all but a "Doomsday" scenario the tax "gross up" provisions in cl 3.4 would mean that DBNZ would inevitably call for conversion to shares.

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[10] Clause 3.1 and the definition of purchase price in cl 1.1.
[11] Clause 3.2
[12] Clause 3.3.
[13] Clause 3.4. The additional amount was calculated by reference to a formula in cl 3.4.

Subsidiary documents

[18] These were threefold.

The Convertible Note guarantee

[19] On 14 March 2003 Groupe Danone SA (the ultimate parent company) entered into a first demand guarantee for the benefit of DBNZ. Under that document Groupe Danone SA guaranteed the payments made by FHNZ under the Convertible Note Deed up to a maximum of $250 million. In return it received a fee equal to 0.10 per cent of the $204 million principal amount advanced to FHNZ. This fee was payable by DBNZ under the Convertible Note Deed.

Mutual acknowledgment as to the lowest price of shares

[20] On the same date DBNZ, DAP and CGD executed a mutual acknowledgment that the lowest price of the FHNZ shares under the Forward Purchase was $204 million (the face value of the Note).[14]

[21] It is common ground that such acknowledgement confirmed, pursuant to the financial arrangements rules in the Act an income tax deduction to DBNZ equal to the difference between the $149 million received from DAP under the Forward Purchase and the $204 million acknowledged lowest price of the shares it transferred to DAP at maturity.

The Forward Purchase guarantee

[22] Again on 14 March 2003, Groupe Danone SA entered into a further guarantee for the benefit of DBNZ in terms of which it guaranteed the payments made by DAP under the Forward Purchase up to a maximum of $67 million. No fee was payable by DBNZ for this guarantee.

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[14] For the purposes of s EH 48(3) of the Income Tax Act 1994, the equivalent of s EW 32 of the 2004 Act with which these proceedings are concerned.

The cashflows, share issues and transfers

[23] These occurred exactly as anticipated by the transaction documents and involved:

(a) DBNZ paying FHNZ $204 million on subscription for the Note.

(b) DAP simultaneously paying DBNZ $149 million under the Forward Purchase Agreement for the shares which DBNZ had the option of taking on the Note's maturity.

(c) FHNZ paying periodic interest at the rate of 6.5 per cent per annum on the $204 million subscription amount up to the maturity date of the Note.

(d) DBNZ paying a guarantee fee of 0.10 per cent on a periodic basis to Group Danone during the currency of the Note.

(e) DBNZ electing to convert the Note for shares on maturity, receiving 1,025 shares from FHNZ; and

(f) DBNZ transferring 1,025 shares to DAP in satisfaction of obligations under the Forward Purchase.

[24] As to application of the subscription monies ($204 million), immediately upon their receipt in 2003 FHNZ paid:

(a) $60 million to DAP by way of a repurchase of 400 shares (thereby reducing its share capital from $150 million to $90 million); and

(b) $144 million to Danone Finance SA (the treasury function of the Danone Group) by way of repayment of earlier advances made by that company.[15]

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15 I discuss initial debt-equity arrangements more fully later in my judgment.

[25] So summarised, the cashflows disclose the genesis of the Commissioner's argument under s BG 1. She says that because the $204 million paid by DBNZ for the Note (and on which interest accrued at 6.5 per cent) was funded as to $149 million by DAP's forward purchase of the shares to be issued under the Note,[16] DBNZ's advance was, in an economically and commercially real sense, $55 million only and the $66 million nominally paid as interest on the Note over its five-year term in fact represented repayment of the principal with $11 million of interest only on the amortising debt. In the result, she disallowed deduction of what she calculated to be the principal repayments totalling $22,492,929 in the two income years in issue.

[26] In summary FHNZ's riposte is that there is no basis to suggest the arrangement as documented is not "economically real". It says the Commissioner's approach wrongly assesses the arrangement's economic effects at a group or consolidated level, contrary to fundamental principles involving the taxation of New Zealand subsidiaries of foreign companies, and incorrectly treats the shares issued by FHNZ as valueless.

The commercial context of the Arrangement

[27] This was provided by FHNZ's sole witness Mr Stanley Marcello Jnr who was the Senior Regional Tax Manager of DAP between April 2015 and November 2016.

[28] Mr Marcello was not personally involved in the transaction at its inception. Indeed he only joined the Danone Group in 2006. Consistent with the authorities requiring the test in s BG 1 to be applied objectively and without reference to the intentions or motives of any party to the impugned arrangement, he confined himself to providing a linking narrative based on the primary transaction documents.[17] In the event, his evidence was largely uncontentious.

[29] Significantly, Mr Marcello described the initial $297,522,000 acquisition by FHNZ of Frucor Beverages Ltd and its subsidiaries in January 2002 as having been funded by way of:

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[16] Itself funded as to $60 million by the capital reduction.

[17] In the manner recognised as appropriate by *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] NZLR 175 at [27].

(a) equity of $150 million from DAP, provided on the issue of 1,000 shares by FHNZ to DAP; and

(b) a loan from Danone Finance SA for the balance of the purchase price under an "Agreement for Operations carried out within Danone Cash Management" (the Cash Management Agreement).

[30] Under the Cash Management Agreement Danone Finance SA maintained a current account for FHNZ which was subject to interest at the "market rate" being the monthly average EURIBOR/LIBOR rate over one month plus 1/8th of one per cent.

[31] FHNZ's statutory accounts to 31 December 2002 record that total advances under the Cash Management Agreement were, at that time, $143,924,000 and it is common ground that, in the period down to repayment from the Note issue, interest of $9,840,466 accrued and was properly deductible to FHNZ. In turn, the interest payment was subject to New Zealand non-resident withholding tax (NRWT) for which Danone Finance SA received a credit against its French tax liability on the interest.

[32] So-described it will be apparent that the initial funding model involved an almost even split between debt and equity on FHNZ's balance sheet immediately following the acquisition.

[33] Almost immediately after the acquisition of Frucor Beverages was settled, however, the Danone Group started to investigate alternative funding structures. This is evident from a January 2002 presentation by Deutsche Bank entitled "Efficient Financing Alternatives for Danone in New Zealand". That document states in its Executive Summary:

> Deutsche Bank understands that Danone is currently looking at various alternatives to (re)finance the acquisition of the New Zealand beverage company Frucor Beverages Group Ltd in connection with its (NZ$ 294 million) take-over offer of all the shares of New Zealand's largest juice maker.

[34] DBNZ proposed two alternative structures, both of which it said had been executed in New Zealand and had received "positive rulings from New Zealand tax advisors" being:

(a) a convertible note structure; and

(b) a structure based on the sale and lease-back of registered trademarks.

[35] The convertible note structure emerged as the preferred refinancing approach. Early iterations had the Forward Purchase undertaken by a United Kingdom or European Danone subsidiary but ultimately DAP was identified as the entity most appropriate.

[36] Referring to contemporaneous documents, Mr Marcello identified the reasons advanced at the time for the transaction as being:

(a) The convertible nature of the note enabled retention of funds within the New Zealand company to facilitate growth as recorded in a contemporaneous Danone memorandum in terms:

> The use of Convertible Notes enables … [FHNZ] to save cashflows (in order to invest and grow faster) as there should be no repayment of the debt but a conversion to shares as opposed to a standard financing.[18]

(b) It would increase FHNZ's equity capital at maturity of the transaction by $204 million, resulting in an expanded capital base to support further investments as recognised in a further contemporaneous Danone memorandum in terms:

> [DAP] … to make a capital increase of NZD 215 M [an earlier indicative transaction figure corresponding to the eventual $204 million] in five years while investing only NZD 150 M [$149 million] today. The NZD 215 M [$204 million] of capital increase in [FHNZ] could be necessary in five years to be able to raise new debts to make investments in New Zealand or Asia.

(c) It would produce an offshore taxation advantage in comparison to alternative funding structures. This was identified as early as DBNZ's January 2002 Efficient Financing document which noted both that:

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[18] Assuming DBNZ elected to take shares which, as indicated, was a reliable assumption in the absence of some unexpected circumstance.

> The coupons paid by NZ entity on the convertible would be fully deductible:
>
> There should be no capital gains tax on the acquisition of the NZ … shares … (provided such shares are not sold).

(d) Such offshore position was subsequently confirmed by advice dated 9 May 2002 from PricewaterhouseCoopers Singapore in terms that DAP would not be subject to Singaporean tax on the difference between the $149 million paid to DBNZ at the commencement of the transaction and the $204 million of shares received on maturity. In his evidence Mr Marcello contrasted this position with that applying to the previous loan from Danone Finance SA under the Cash Management Agreement. In that context the interest deductions which FHNZ was entitled to take gave rise to taxable income in France. The Arrangement therefore allowed for FHNZ to preserve its New Zealand tax deductions for interest paid on debt funding (albeit formerly subject to NRWT) while altering the Danone Group's offshore tax treatment of its funding of FHNZ.

(e) It provided committed five-year funding to FHNZ at a fixed rate rather than the floating rate charged under the Cash Management Agreement. This aspect was identified in the same memorandum referred to in sub para (a) above:

> The use of the Convertible Note enables … [FHNZ] to hedge its interest rate and liquidity on the medium term as it is a fixed rate medium term financing (versus a floating rate short term financing up to now). Our International Treasury confirms that a financing through a bilateral bank line would have been more expensive.

Other internal and contemporaneous memoranda variously describe the arrangement as providing "a cost of funding more alternatives than Frucor would have obtained from plain borrowings" and that the "benefits obtained" included "Financing Cost: extremely attractive for NZD financing".

(f) It was consistent with the Danone Group's policy to create a natural currency hedge for cashflows generated outside Europe by funding the relevant investments with local debt. This was referenced in an undated but contemporaneous Danone Group memorandum identifying "why the Group needs to hedge its cashflows from foreign investments by funding such investments with local debt" and the fact that refinancing through issue of convertible notes "answers to the objectives of the above policy". In a further Danone Group internal memorandum, dated 11 March 2003 the same point was made in terms:

> "Benefits obtained
>
> …
>
> NZD financing: putting a debt in the same currency as cash-flows of the company acquired provides us with a natural hedging; furthermore, interest are [sic] located in the same country as operating income.

(g) To better balance the debt to equity position of the New Zealand group during the term of the Note by application of part of the Note proceeds to the repurchase of shares from DAP. In the memorandum referred to in sub para (a) above this was stated as "the purpose of the transaction" and it was to enable an "increase [in] value creation for the New Zealand Group".[19] Likewise in an undated Frucor Beverages Ltd memorandum, which in its terms appears to have been prepared shortly after the Arrangement came to an end and within the 2008 tax year, the "key commercial divisions" of the transaction were stated to include:

> To attain a more appropriate debt to equity level for the New Zealand Group.[20]

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[19] I record the content of the Memorandum, as Mr Marcello did, without elevating declared subjective purpose at the time to a relevant consideration in terms of application of s BG 1.

[20] The other identified "drivers" are noted as:

- Securing fixed term funding at a lower cost of borrowing under a convertible note facility than under a more expensive syndicated loan structure.
- To fund the New Zealand operations in a manner consistent with Groupe Danone's policy for subsidiaries to self-finance as much as possible and prevent any shares being held by an entity outside the Danone Group by use of a forward purchase agreement.

It was common ground between the parties that as a result of the repurchase of shares the debt-equity ratio on FHNZ's balance sheet increased from approximately 50:50 to approximately 63:37.

The basis of the Commissioner's assessments

[37] The Commissioner reassess FHNZ's income tax position on the basis that s BG 1 permits her to treat $55 million of the payments made by FHNZ on the Note as repayment of non-deductible loan principal.

[38] As FHNZ submits, the Commissioner's case is "not grounded in the argument that the Arrangement gave rise to income tax deductions that did not exist before the arrangement was entered into and was accordingly, for that reason alone, a tax avoidance arrangement". Nor could it because, limited only by the thin capitalisation rules,[21] it was always open to the Danone Group to introduce additional debt funding to FHNZ and to retire a portion of its equity funding. And as Mr Marcello said in evidence (which I accept), broadly equivalent tax deductions to those claimed under the Arrangement would have been available if the initial financing under the Cash Management Agreement had been retained.[22]

[39] Rather the Commissioner has, at various times, advanced two principal and one now-abandoned alternative approach to application of the anti-avoidance provisions.[23]

[40] The abandoned alternative approach was introduced in the Commissioner's revised Notice of Proposed Adjustment dated 22 October 2010. It was premised on a rejection by the Court of her primary argument that the (greater) portion of FHNZ's claimed interest deductions should be denied. It assumed a deeply discounted zero-

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[21] Which do not limit the amount of debt that may be introduced but only the deduction of interest paid on that debt. I will refer to these rules in greater detail later.

[22] Mr Marcello's reconstruction of interest payable under the Cash Management Agreement, had it been retained, indicated deductions of $10,619,354 in the 2006 year and $11,263,777 in the 2007 year. This compares with claimed deductions under the Arrangement (on the higher principal sum of $204 million) of $13,250,998 and $13,323,806 respectively and the interest deductions allowed by the Commissioner of $2,423,392 and $1,658,483 based on her reconstruction.

[23] FHNZ's submission being that the several changes in the Commissioner's approach reflect adversely on the reliability of her avoidance analysis.

coupon bond with a face value of $204 million, an issue price of $149 million and NRWT on the deemed accretion of deductible interest over the term of the bond.

[41] The remaining approaches are those advanced in the Commissioner's statement of position dated 25 January 2011 and in the Adjudication Report dated 22 November 2011 issued by the Commissioner's Adjudication Unit.[24]

Approach in statement of position dated 25 January 2011

[42] Under this approach the Commissioner argues the presence of the Forward Purchase Agreement reduces the "real" or "economic" amount borrowed by FHNZ from $204 million to a "net loan" of $55 million with a commensurate reduction in interest entitlements.

[43] Because of the acknowledged receipt by FHNZ of $204 million and its application by way of capital return and repayment of facilities under the Cash Management Agreement, the Commissioner recharacterizes the $149 million as a payment made directly by DAP to FHNZ by way of an equity injection for which no deduction arises. That approach is premised on the fact that under the Forward Purchase, DBNZ would, having elected to take shares, hold them for a scintilla in time only before transferring them to DAP. In the result, the Commissioner characterises DAP as having "paid for shares which it knew it would receive in the future" so that the payment should be seen as "an equity injection in substance" despite the shares not being issued or received for five years.

[44] On this basis the Commissioner defines the "real" arrangement as being:

(a) A $55 million advance from DBNZ to FHNZ repaid as to both principal and interest on an amortising basis over the term of the Note, with payments of $55 million comprising principal, and interest deductibility limited to $11 million.

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24 The parties agree that since this Court operates as a "hearing authority" for the purposes of the Tax Administration Act 1994, my jurisdiction is not limited by either of the positions referred to (s 138P). In argument Mr Smith QC stated that the first alternative "remains on the table" but that "the Commissioner's primary argument is theory 2".

(b) A $149 million advance subscription by DAP for the issue of equity in FHNZ in five years' time, with no income tax implications either in respect of FHNZ's receipt of the sum, its retention for the five-year period or issue of the shares at the conclusion of the Arrangement.

(c) The aggregate $204 million being available to FHNZ for the term of the Note.

(d) Liabilities in respect of that $204 million being fully discharged by FHNZ through the issue of shares in five years' time.

Approach of Adjudication Unit, 22 November 2011

[45] The Adjudication Unit appears not to have been persuaded by the approach adopted in the statement of position. It clearly regarded the approach as involving a recharacterisation which breached the "economic equivalence" prohibition confirmed in *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd*[25] and other authoritative decisions under s BG 1, including the High Court and Court of Appeal decisions in *Accent Management Ltd v Commissioner of Inland Revenue*, later known in the Supreme Court as *Ben Nevis*[26] (all as endorsed in the Commissioner's own interpretation statement on s BG 1).[27]

[46] Its alternative position was, as I consider Mr L McKay fairly puts it, to regard FHNZ's position as essentially the "reflex" of DBNZ's economic position. Accordingly, the Adjudication Unit considered:

(a) DBNZ's economic outlay on the subscription was $55 million only (having received the $149 million prepayment from DAP).

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25 *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641 (PC) at 648 per Lord Wilberforce.

26 *Accent Management Ltd v Commissioner of Inland Revenue* (2005) 22 NZTC 19.027 (HC) at [135]–[142]; and *Accent Management Limited v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21.323 (CA) at [97]–[100] and [118].

27 Public Rulings Unit, Office of the Chief Tax Counsel *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (IS13/01, 13 June 2013).

(b) in return for that economic outlay, DBNZ received $66 million in interest over the term of the Note and, having regard to its initial outlay, this resulted in a net return of $11 million in economic terms.

(c) FHNZ's economic position was equivalent. It received $204 million from DBNZ and paid $66 million to it. It also issued shares to DBNZ on termination of the arrangement which, although they represented consideration such as to discharge FHNZ's obligations under the Note, had no economic cost to FHNZ.

[47] The Adjudication Report noted:

> 3.188 This leaves the $66 million the Taxpayer paid to Deutsche Bank. The Taxpayer argues that the entire $66 million was its [interest] cost under the Note. However, this is inconsistent with Deutsche Bank's $75 million economic cost under the note and its $11 million return. Deutsche Bank's $11 million return under the Arrangement suggests that only $11 million of the Taxpayer's $66 million outgoing represents a cost to the Taxpayer. The $55 million balance appears to be repayment of part of the $204 million lent under the Note …
>
> …
>
> 3.191 … The balance of the $204 million (that is $204 million less $55 million, being $149 million) does not appear to be repaid by the Taxpayer other than by issuing of shares. There was no cost associated with the issuing of shares. This left the Taxpayer with a $149 million gain.

[48] This alternative approach does not involve recharacterisation of DAP's $149 million payment to DBNZ as prepayment of equity to FHNZ. Indeed the approach treats DAP's payment as being made to DBNZ so as to reduce its economic exposure to $55 million. It is because DBNZ is seen to have an economic outlay of $55 million and an economic return on that outlay of $11 million that FHNZ's claim for deduction of the full $66 million is said to be "inconsistent" with DBNZ's position.

The Commissioner's expert evidence

[49] The Commissioner called two expert witnesses: Professor Lewis Evans and Professor Moorad Choudhry. Professor Evans is an Emeritus Professor of Economics at Victoria University of Wellington. He holds a doctorate in economics and has had

a distinguished career in that field, including a Fellowship of the Law and Economics Association of New Zealand and a Distinguished Fellowship of the New Zealand Association of Economists. Professor Choudhry is an Honorary Professor of the University of Kent Business School. He has a doctorate in financial economics and, in combination with his successful career in the banking industry, has published extensively on the subject of banking and financial products.

[50] Both experts gave evidence on the commercial and economic effects of the transactions (or aspects of them) in issue in the proceedings.

[51] Professor Evans considered that, overall, the transaction "had the effect of the [Danone] Group borrowing and repaying $55.4 million over five years and rendering interest and principal repayment tax deductible." He estimated that $11.1 million of the $66.5 million coupon repayments were properly characterised as interest, with the remaining amounts being repayment of principal.

[52] He defined the transaction to consist of "the actions specified in the Convertible Note Deed, the Forward Purchase Deed, the two guarantees and the Fee Arrangements". He explicitly excluded "transfers that can be considered ancillary to the transaction" including the use to which FHNZ put the $204 million it received from DBNZ and the $89 million third-party financing received from BNP Paribas.

[53] He calculated that at the close of the transaction the Danone Group experienced an economic cost of $2.1 million, reflecting the fees paid to enter the arrangement.

[54] However, he further explained that, "while the transaction provides a negative pre-tax value to the Danone Group, it is significantly positive on a post-tax basis." He considered this to be the case irrespective of the form of settlement (by share conversion and transfer, novation or cash payment) and attributed such result to the fact that the coupon payments were fully tax deductible.

[55] In the case of conversion and transfer he stated that:

(a) Adopting a discount rate of 6.4 per cent[28] and discounting to the date of closure of the transaction (18 March 2003), the pre-tax cost to the Danone Group was $2,092,793.

(b) Because in his view the "issuance and concomitant transfers of shares have no cost to the entity that is FHNZ" the value of that entity "increases substantially" from the CN transaction. He identified that increase as $146,041,192 on a discounted basis, all attributable to "transfers within the Danone Group".[29]

(c) On a post-tax basis[30] and assuming full deductibility for the coupon payments the transaction enhanced the value of the Danone Group by approximately $14.9 million at the date of closure (with a $162,252,097 uplift in value to FHNZ, a $149 million reduction in value to DAP and a $611,000 increase to Groupe Danone SA.[31]

(d) Assuming that the coupon payments of $55.4 million in fact constituted principal payments of $44.3 million and interest payments of $11.1 million (which was the Professor's thesis) and that only the latter was deductible (as the Commissioner contends), the post-tax value to the Danone Group would have been approximately negative $1.4 million at the date of closure.

[56] Accordingly, he concluded that:

> The value of the Danone Group is enhanced by approximately $16.2 million by principal repayment deductibility of the coupon payments: being the difference between the present value of $14.9 million with full deductibility and $1.4 million with interest only deductibility.

[57] The Professor posited that this resulted in the New Zealand tax base subsidising the borrowing, at "social, equivalently economic, cost to New Zealand."

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28 Being the difference between the coupon rate of 6.5 per cent and the guarantee fee of 0.1 per cent.
29 Derived from DAP's payment of $149 million.
30 Using a post tax discount rate of 4.29 per cent being 6.4 per cent less tax of 33 per cent.
31 Being the guarantee fees it received.

[58] In the case of novation, Professor Evans identified the same $16.2 million enhancement to the Group on a post-tax basis and the same pre-tax cost of $2.1 million, with the only significant change being that "FHNZ's value from the [convertible note] transaction changes to negative because of the $204.4 million payment at settlement".

[59] Under the cash repayment alternative, Professor Evans calculated the amount required to be paid by DBNZ to DAP as $218.3 million.[32] Having regard to the $204.4 million paid by FHNZ to DBNZ under this scenario, the Professor noted that "this changes the economic effects of the transaction assessed on a pre-tax basis".

> The transaction is now positive on a pre-tax basis for the Danone Group and negative to the DBNZ group, in the order of $8.1 million in present value terms at the date of closure …. However, Singaporean taxation affects the post-tax outcome.

[60] On a post-tax basis and assuming a Singaporean tax rate of 20 per cent[33] he again concluded that from the perspective of the Danone Group there would have been a $16.2 million (discounted) advantage arising from what he termed "full deductibility versus interest only deductibility".

[61] However, the Professor calculated DBNZ's position to be materially worse under the cash settlement option — identifying a "value fall" of $8.1 million on a pre-tax basis and $9.9 million on a post-tax basis.

[62] And, as with the novation option, settlement by cash payment meant that FHNZ's "value" from the transaction changed to negative.[34]

[63] This can be contrasted with Professor Evans's view that, under the share conversion and transfer option, FHNZ suffered no economic cost when it issued shares to DBNZ, and suffered no further economic cost when those shares were transferred

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32 His calculation assumed that no acceleration event had occurred and that the applicable Singaporean tax rate at the relevant time was 20 per cent.

33 Professor Evans acknowledged in his brief that he understood the relevant Singaporean tax rate varied between 2003 and 2008 (reducing over that time from 22 to 18 per cent) but nothing turned on this variation.

34 The corresponding value "uplift" being to CGD in the case of novation and DAP in the case of cash settlement.

to DAP — an opinion which formed one of the pillars of the Commissioner's s BG 1 argument. In his brief of evidence the Professor put the position as follows:

> 87. The economic cost is measured by changes in the cash surplus of FHNZ going to its shareholders. There is no economic cost to FHNZ in the issuance of shares *per se*. There will be dilution of per-share payments to the share owners (dividends per share) but not of the aggregate company dividend that is available for distribution to owners. For there to be an economic cost or benefit the issuance and transfer would have to effect some change in decisions that affected the value of FHNZ. There is no reason to expect different management because of the act of issuing the shares. Setting aside the small cost of the legal process of issuance there is no obvious rationale for the issuance and associated dilution of per-share dividend to have economic costs or effects for FHNZ.
>
> …
>
> 88. DAP did not suffer an economic cost when the [convertible note] converted to shares. I have explained that the issuance of additional shares in FHNZ would have de minimis legal costs, but otherwise no costs to the shareholders. In addition the act of transfer of shares to DAP had no economic or commercial costs (excepting de minimis legal costs) for either FHNZ or DAP. DAP owned the shares before and after the issuance and transfer of the shares. The issue and transfer of shares simply shuffled the ownership records of DAP. They were, with the legal process cost caveat, costless and had no effect on the ownership and control of FHNZ, or DAP.

[64] Significantly, however, even in respect of the cash novation option[35] Professor Evans considered that the coupon payments would still exhibit features of principal payment deductibility for the Danone Group from an economic perspective.

[65] I accept FHNZ's submission that while this may be correct from the Professor's economic perspective, it cannot be correct as a matter of New Zealand tax law or be considered consistent with Parliamentary intent. The Commissioner could have no objection to a deduction accruing to FHNZ for the full $66 million of coupon payments under the novation or cash settlement alternatives. In both such cases the $66 million would simply represent the price of the money, borrowed and ultimately repaid by the same taxpayer, over the life of the instrument. The fact that Professor Evans's economic perspective suggests that such an arrangement would involve principal payment deductibility does tend to emphasise the divergence between his economic

[35] And presumably also cash settlement option.

model, itself premised on a group approach, and Parliament's assumed intentions about the operation of New Zealand's tax rules. I consider that a significant caveat in terms of what importance I should place on the Professor's evidence.

[66] Professor Choudhry's evidence drew broadly consistent conclusions to that of Professor Evans.

[67] He considered the transaction unconventional in a number of material respects. For a start he said that convertible bonds and notes were characteristically priced on the basis of a "volatility play" with the borrower benefiting from obtaining funding at an interest rate that is lower than it otherwise would be if it issued straight "vanilla debt" and the lender acquiring the right to shares at a potentially cheaper price than if it subscribed at the time of the note's maturity. He suggested that none of these considerations influenced the pricing of the DBNZ note.

[68] In his view an unrated and unlisted wholly-owned subsidiary would never feasibly be able to use a convertible bond to raise funds because, unless the company was the subsidiary of a listed parent and that parent was itself considered a proxy for its subsidiary's position,[36] there would be no share price volatility to observe and thus no way to value the embedded option in the bond.

[69] He said it would also be usual for a company raising money through a convertible bond to identify, by way of an offer document, the purpose for which the funds were to be used and that this was not the case here. And, in a related point he drew a comparison with the orthodox situation where the amount of the bond is linked to some specific capital requirement and is in a rounded sum. The face value of the DBNZ bond, he said, "was arrived at in what can only be described as an unorthodox and not market conventional fashion", which worked backwards from the coupon rate resulting in a principal amount Professor Choudhry described as "a very exact number" that "is not commonly how conventional bond issue notional amounts convertible or otherwise are arrived at in the market".[37]

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[36] A proposition with obvious limitations.

[37] The evidence established that the value of the Note was established by adding the present value of five years' worth of coupons (priced by the Deutsche Bank swaps desk in London) to the Forward Purchase payment amount of $149 million. The resultant amount was $204,421,565.

[70] And significantly, he relied on what he considered to be the unorthodox manner in which the note was priced, contrasting:

(a) The typical case where the issuer is listed or an exchange, is rated and has "a transparent share price" and where the rate is set by taking the baseline coupon (the ordinary rate for a vanilla fixed coupon bond) and making an adjustment downwards based on the value of the embedded option in the bond (which is itself a function of the volatility of the share price and the time to conversion); and

(b) The pricing in this case, which was simply referenced off the NZD swap curve with a spread of 30 basis points as "expected for an A1/A+ rated borrower".[38]

[71] Professor Choudhry's views also aligned with those of Professor Evans when it came to the "economic substance" of the transaction:

> 33. Because of the number of parties connected to the deal, it is illogical to view the transaction economically as a standalone one or from the viewpoint of the bond issuing entity alone. The deal included DAP, DBNZ, the novation counterparty CGD, and Groupe Danone (the ultimate parent of FHNZ). When the transaction is viewed from a wider perspective, FHNZ has paid interest of $11.09 million on a borrowing of $55.42 million. In addition, FHNZ benefits from an interest-free injection of cash, via the [forward purchase] arrangement, of $149 million for 5 years from its parent DAP.

[72] And he took a similar position to Professor Evans in respect of the absence of economic cost to FHNZ on the issue of shares to DBNZ saying:

> 55. Issuing shares to the Note holder on maturity had no effect, economic or otherwise, because the shares were transferred simultaneously to its existing parent DAP, who already owned 100% of the shares in FHNZ. I can deduce no economic cost to FHNZ in this circumstance. …
>
> …
>
> 57. From a practical economic and control (ownership) viewpoint there was no cost or impact from the conversion of the note debt to shares in FHNZ. This does not mean there would have been no book-keeping impacts, primarily accounting entries in the general ledger,

38 Which FHNZ effectively was with the Groupe Danone SA guarantee.

> but this has no practical impact from an economic cost and ownership viewpoint; there was no cash flow cost at all.

[73] Significantly, both experts considered the economic effects of the transaction on the Danone Group *as a whole*. Professor Evans referred to the Danone Group as consisting of FHNZ, DAP, Groupe Danone SA, CGD and Danone Finance SA. In cross-examination, he explained that the economic costs or benefits to a company in turn required reference to its shareholders and that his approach was "a summary way of treating the commercial and economic performance of the company as being the benefit to the shareholders, in the absence of externalities". Indeed he went further and said that "to me the company is the shareholders", a proposition which is open to obvious objection as a statement of legal principle.[39]

[74] Likewise Professor Choudhry said:

> [T]his was a transaction involving three group entities designed to facilitate a particular desired outcome above and beyond securing term funding. As such, it would not be logical from a banking perspective to view this transaction purely with regard to one legal entity. It is the consolidated impact that must be considered.

[75] However, as the following extract from his cross-examination confirmed, he accepted that, looked at as a separate entity, FHNZ had received and applied the full amount of the note and that the interest paid by it reflected a coupon rate of 6.5 per cent on the sum advanced:

> Q. … If we just stay with Frucor Holdings again on that separate entity basis, would you agree that Frucor Holdings received 204 million from DBNZ?
>
> A. Oh yes absolutely. In my view … there's no doubt about that. It issued paper to DBNZ and received 204 million, yes.
>
> Q. And again from [a] Frucor Holdings New Zealand entity standpoint there's nothing in your term on several occasions this morning nothing nominal about that 204?
>
> A. Are you asking me if it's real money?
>
> Q. Yes.
>
> A. Oh yes.

[39] See s 15 of the Companies Act 1993, confirming that a company is a legal entity in its own right separate from its shareholders.

Q. And it is real to the extent of 204 million?

A. Well, yes, FHNZ from my reading of the documents, FHNZ receives 204 million on issue date from DBNZ, yes.

Q. And it's also from paragraph 39 of your evidence accepted by you that it spent 204 million?

A. Yes that my – from the documents that's what it appeared to have done, yes.

Q. And this time from paragraph 31 of your evidence, I think it's accepted by you that on an entity basis it paid 66 million for its use of that 204—

A. It made a coupon of six and a half per cent on 204 million, yes.

Q. Aggregating around 66 million?

A. That's right, yes.

Comparison of experts' approach with accounting treatment

[76] The "group" approach adopted by Professors Evans and Choudhry was reflected in the consolidated accounts for Danone. In his brief of evidence Mr Marcello explained that the Danone Group (including FHNZ) adopts International Financial Reporting Standards (IFRS) to prepare its financial statements. IFRS 10 requires an entity that controls one or more other entities to present consolidated financial statements. IFRS 10 defines "consolidated financial statements" as:[40]

> The financial statements of a **group** in which the assets, liabilities, equity, income, expenses and cash flows of the **parent** and its **subsidiaries** are presented as those of a single economic entity.
>
> (Emphasis in original).

[77] By contrast, FHNZ's own accounts were prepared on a "standalone basis" and reflected the gross cash flows it received under the transactions.

[78] In the result, the evidence (including not only the financial statements but a number of internal documents, emails and spreadsheets) uniformly established reference to a "net loan" of $55 million in the context of documents concerning DBNZ,

[40] IFRS Foundation "IFRS 10: Consolidated Financial Statements" at A477.

DAP or the Danone Group generally. And in the context of FHNZ they referred in a similarly uniform way to the full face value of the borrowing namely $204 million.[41]

[79] In FHNZ's submission all this says is that although Professor Evans' and Professor Choudhry's "group" approach was mandated (and followed) at a consolidated accounting level, such is the limit of its applicability. It was not relevant in terms of FHNZ's accounting treatment at an entity level and, even more particularly, is not relevant to the principal inquiry under s BG 1 for the reason that, in applying s DB 7 and the financial arrangements rules, Parliament did not intend a "group" approach. I expand on this submission in subsequent sections of this judgment. In doing so, however, I emphasise that FHNZ did not submit that the tax treatment of the arrangement must necessarily replicate the accounting treatment. That would be to promote a long-discredited view. Rather the argument about accounting methodology was advanced to illustrate the areas of consistency and difference between accounting treatment and expert evidence.

The tax avoidance framework

[80] As indicated, the Arrangement was governed by the provisions of the 2004 Act. Under s BG 1(1) of the Act, "[a] tax avoidance arrangement is void as against the Commissioner for income tax purposes." The Commissioner may then "counteract" the "tax advantage that a person has obtained" under pt G of the Act.[42] This is known as "reconstruction".

[81] The Act defines "arrangement", "tax avoidance" and "tax avoidance arrangement" in s OB 1 (definitions). An arrangement is "an agreement, contract, plan, or understanding (whether enforceable or unenforceable), including all steps and

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41 There is one exception. One document, an "approval paper" prepared by DBNZ, referred to FHNZ receiving net funds equal to the difference between the convertible note and the forward purchase. But that document reflected a different structure to the transaction than the one ultimately adopted. At the time it was suggested that FHNZ would use the entire forward purchase amount (then $154m) towards repayment of its establishment equity (i.e., the $154m would be immediately paid from DAP to DBNZ, DBNZ to FHNZ and FHNZ back to DAP). This feature of the transaction did not eventuate, with FHNZ instead only redeeming $60m of its establishment equity in order to rebalance its debt to equity position. I do not therefore consider the netted figures referred to in this document are materially relevant to the Arrangement as it eventuated.

42 Income Tax Act 2004, s BG 1(2).

transactions by which it is carried into effect”.[43] The definition is broad and the parties agree that the transaction amounts to an arrangement.

[82] Tax avoidance is not defined exhaustively; rather the Act says it “includes”:[44]

> (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

[83] Finally, a “tax avoidance arrangement” is defined as follows:[45]

> **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 purpose or effect is not merely incidental

[84] These provisions, taken together, are referred to as the general anti-avoidance rule (or provision). I pause to make a brief observation on the words “purpose or effect” in the last definition. As will be clear from the discussion that follows, the question of tax avoidance is objective. In *Glenharrow Holdings Ltd v Commissioner of Inland Revenue*, the Supreme Court said that (despite the word “purpose”) the inquiry is not into the subjective intentions of the taxpayer but rather involves asking “what objectively was the purpose of the arrangement, which in turn requires examination of the effect of the arrangement.”[46] And so, “working backwards as it were from the effect, you are able to determine what objectively the arrangement must be taken to have had as its purpose.”[47]

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43 Section OB 1, definition of “arrangement”.

44 Section OB 1, definition of “tax avoidance”.

45 Section OB 1, definition of “tax avoidance arrangement”.

46 *Glenharrow Holdings Ltd v Commissioner of Inland Revenue* [2008] NZSC 116, [2009] 2 NZLR 359 at [36].

47 At [38], applying Lord Denning’s approach in *Newton v Commissioner of Taxation for the Commonwealth of Australia* [1958] AC 450 (PC) at 465.

[85] The difficulty caused by the broad scope of the general anti-avoidance rule has been extensively discussed.[48] It was the subject of detailed comment in the Supreme Court's judgment in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*.[49] As Tipping and McGrath JJ explained in the majority judgment:[50]

> Taxpayers enter into many transactions which have been structured with the purpose of taking advantage of specific provisions in order to reduce tax. While the general anti-avoidance provision is expressed broadly, its purpose cannot be to strike down arrangements which involve no more than appropriate use of specific provisions. On the other hand, strict compliance with the requirements of specific provisions cannot have been intended to immunise all arrangements involving their use against being categorised as tax avoidance arrangements, which it was the purpose of the general provision to avoid.

[86] The majority summarised their approach by explaining that appropriate effect must be given to each of the specific provisions *and* the general anti-avoidance provision — "they work together."[51] The focus is on whether the use of the specific provisions has crossed the line and transformed a "permissible arrangement into a tax avoidance arrangement,"[52] The inquiry is one not to be distracted "by intuitive subjective impressions of the morality of what taxation advisors had set up".[53]

[87] The High Court has previously observed that it is generally unnecessary to review the law on tax avoidance as it stood before *Ben Nevis,* except insofar as some decisions remain material to specific parts of the overall inquiry.[54] In this case the parties similarly focused their analysis on *Ben Nevis* and referred to other cases only when necessary to elaborate on specific aspects of the tax avoidance framework.

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[48] See, for example, Michael Littlewood "Tax Avoidance, the Rule of Law and the New Zealand Supreme Court" [2011] NZ L Rev 35 and the cases and articles cited therein.

[49] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289.

[50] At [12]. Tipping and McGrath JJ wrote on behalf of themselves and Gault J. Elias CJ and Anderson J agreed with the conclusion reached by the majority but expressed reservations about the majority's approach to the interpretation of the relevant provisions.

[51] At [103]. In John Prebble *Fundamentals of Income Taxation* (Thompson Reuters, Wellington, 2018) at 412, the author describes this tandem approach as "not particularly helpful because the GAAR often overrides a specific provision" and "whenever it is invoked it is dominant". However, he acknowledges as "true that the application of the GAAR is informed by the apparent objectives of the remainder of the Income Tax Act 2007."

[52] At [104].

[53] At [102].

[54] See *BNZ Investments Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,582 (HC) at [114] and *Westpac Banking Corp v Commissioner of Inland Revenue* (2009) 23 NZTC 23,834 (HC) at [170].

[88] In *Ben Nevis* the Supreme Court posited a two-stage inquiry to determine whether an arrangement is a tax avoidance arrangement.

[89] First, "[t]he taxpayer must satisfy the court that the use made of the specific provision is within its intended scope."[55] Such is not in issue here. The Commissioner accepts that the transaction met the "black-letter" of s DB 7 (relating to interest deductibility) and of the financial arrangements rules in the Act. Both are discussed in more detail below.

[90] The outcome of this case therefore depends on the second stage of the inquiry. In terms of the *Ben Nevis* test, this involves an examination of the use of the specific provision "in light of the arrangement as a whole."[56] The focus is on whether the taxpayer has used the specific provision "in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision".[57]

[91] It is not necessary, however, for Parliament to have contemplated the specific transactions in issue. As Wild J said in *BNZ Investments Ltd v Commissioner of Inland Revenue*:[58]

> I agree with Mr Brown's submission for the Commissioner that it is unreal to suggest that Parliament, when it enacted the deductibility and subvention provisions and the FTC and conduit regimes, might actually have contemplated transactions structured as are those in issue in these proceedings.

[92] In *Ben Nevis* the Supreme Court emphasised that enquiries into tax avoidance are primarily exercises of statutory interpretation. Ascertaining whether the use of specific provision "cross[ed] the line" is to be "firmly grounded in the statutory language of the provisions themselves".[59] The Court explained that the general anti-avoidance rule functions:[60]

> … to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act.

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55 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [107].
56 At [107].
57 At [107].
58 *BNZ Investments Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,582 (HC) at [134].
59 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [104].
60 At [106].

[93] The statute does not confine the Court's inquiry; rather, the Supreme Court observed that "the Commissioner and the courts may address a number of relevant factors, the significance of which will depend on the particular facts."[61] The Court posited the following examples:[62]

(a) The manner in which the arrangement is carried out;

(b) The role of all relevant parties and any relationship they may have with the taxpayer;

(c) The economic and commercial effect of documents and transactions;

(d) The duration of the arrangement;

(e) The nature and extent of financial consequences the arrangement will have for the taxpayer;

(f) Whether the arrangement was structured so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way.

[94] In some cases artificiality may be indicated not by the structure itself but by the rates at which a deduction is taken, or for example a salary. In *Penny v Commissioner of Inland Revenue*, for example, the Supreme Court considered the adoption of "a familiar trading structure" (incorporation of a company and transfer of personal business to that company) "cannot per se be said to involve tax avoidance".[63] But Parliament could not have been seen to contemplate "using a company structure to fix the taxpayer's salary in an artificial manner."[64] A "gross disparity between the price and size of the purchaser" was also indicative of tax avoidance in *Glenharrow Holdings*.[65] In that case, the Supreme Court explained why a factor such as "commercial effect" is relevant; because "[t]ransactions which are driven by

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[61] At [108].
[62] At [108].
[63] *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433 at [33].
[64] At [47].
[65] *Glenharrow Holdings Ltd v Commissioner of Inland Revenue* [2008] NZSC 116, [2009] 2 NZLR 359 at [54].

commercial imperatives are unlikely to produce tax consequences outside the purpose of the legislation”.[66] Although it would be incorrect to describe underlying commercial purpose as immunizing a transaction from challenge under s BG 1, it is nevertheless a significant consideration both at the threshold and potentially “merely incidental” steps of the inquiry.[67]

[95] A focus on individual factors (like artificiality or commerciality) may indicate Parliament’s intention but cannot detract from the “ultimate question” which the Supreme Court in *Ben Nevis* identified as:[68]

> … 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. 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.

Section DB 7 and the financial arrangements rules

[96] The transaction relied on two separate parts of the Act: the interest deductibility provisions and the financial arrangements rules. Accordingly, *Ben Nevis* mandates that I consider the “intended scope” of both sets of provisos within “the overall scheme of the Act.[69]

[97] Under s DB 7(1) of the Act, “A company is allowed a deduction for interest incurred.” Interest is defined in s OB 1. It “includes expenditure incurred under the financial arrangements rules”.[70] Interest is “incurred” where a legal obligation to make a payment in the future has accrued, the taxpayer is definitely committed to it and it is more than impending, threatened or expected.[71] FHNZ submits that s DB 7 provides for an “unqualified entitlement”[72] to deduct the $66 million in payments made to DBNZ, save only for potential application of s BG 1.

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66 At [49].

67 See, for example, *Westpac Banking Corp v Commissioner of Inland Revenue* (2009) 23 NZTC 23,834 (HC) at [206].

68 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [109].

69 At [106].

70 Income Tax Act 2004, s OB 1, definition of “interest” at (d)(i).

71 *Case Y17* (2008) 23 NZTC 13,171 (TRA) at [31]. See also *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Ltd* [1995] 3 NZLR 513 (PC) at 517.

72 The phrase was Mr (L) McKay’s.

[98] That approach is supported by both policy and pragmatic considerations. In an article examining the calculation of interest, Sir Ivor Richardson observed:[73]

> Dissecting interest payments and receipts on income account so as to exclude any capital elements would be costly and uncertain. There is usually no incentive for tax reporting purposes to depart from the historical position of treating the full percentage rate of interest as income of the recipient and as a revenue deduction against income of the payer.
>
> That characterisation can cause problems … where hybrid arrangements may be mischaracterised as debt (or equity) under corporate law or revenue law (where the Commissioner of Inland Revenue can invoke special legislative provisions and the general anti-avoidance provision). …

[99] The legislative history of s DB 7 indicates that it was intended to provide companies with a deduction as soon as interest was incurred and without reference to some of the historic restraints which applied. The Commissioner explained the introduction of new interest deductibility rules for companies in a *Tax Information Bulletin* in November 2001:[74]

> The general interest deductibility rules for companies have been clarified and simplified. The changes ensure that interest incurred by most companies is deductible, subject to the existing thin capitalisation and conduit interest allocation rules. …
>
> The purpose of these changes is to reduce compliance costs for taxpayers by removing both the uncertainty that surrounded these tax rules and their need to structure to achieve the same result.
>
> …
>
> For the majority of companies, interest deductions are no longer confined to interest incurred either in deriving gross income, or in the course of carrying on a business, or in relation to borrowings used to capitalise subsidiaries.

[100] Both the section and the policy behind it therefore indicate that a taxpayer is entitled to a deduction for interest that has been incurred whether or not for the purposes of deriving gross income, carrying on a business or in relation to borrowings to capitalise subsidiaries. I accept in that context Mr McKay's characterisation of the rule as providing the taxpayer with an "unqualified entitlement" to deduction where interest is incurred, subject of course to s BG 1.

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73 Ivor Richardson "The Calculation of Interest" (2014) 20 NZJTLP 231 at 249.

74 Inland Revenue Department "Interest Deductibility for Companies" (2001) 13(11) *Tax Information Bulletin* 34 at 34.

[101] Turning then to the financial arrangements rules, these are provided for in sub-pt EW of the Act. The Act identifies three purposes to the rules:[75]

> (a) to require the parties to a financial arrangement to accrue over the term of the arrangement a fair and reasonable amount of income derived or expenditure incurred under the arrangement, and so to prevent the deferral of income or the advancement of expenditure; and
>
> (b) to require the parties to a financial arrangement to disregard any distinction between capital and revenue amounts; and
>
> (c) to require a party to a financial arrangement to calculate a base price adjustment when the rights and obligations of the party under the arrangement cease.

[102] A financial arrangement includes "an arrangement under which a person receives money in consideration for that person, or another person, providing money to any person" either "at a future time" or "on the occurrence or non-occurrence of a future event, whether or not the event occurs".[76] A debt and a debt instrument are specifically contemplated to be financial arrangements.[77]

[103] Though the financial arrangements rules "require the parties to a financial arrangement to disregard any distinction between capital and revenue amounts",[78] they nonetheless recognise the distinction between debt and equity. That is clear from the list of excepted financial arrangements.[79] An "excepted financial arrangement" is not a financial arrangement.[80] Excepted financial arrangements include "a share, or an option to acquire or to dispose of shares",[81] but "[a]n excepted financial arrangement may be part of a financial arrangement."[82] In this case the option to acquire shares itself formed part of a broader financial arrangement which included the Note.

[104] Ordinarily a financial arrangement is taxed on the basis that all returns on the arrangement, whether income or capital in nature, are brought to tax.[83] It also requires

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75 Income Tax Act 2004, s EW 1(3).
76 Section EW 3(2).
77 Section EW 3(3)(a) and (b).
78 Section EW 1(3)(b).
79 Section EW 5.
80 Section EW 4(3).
81 Section EW 5(12).
82 Section EW 6(1).
83 Section EW 15.

all income and expenditure related to the arrangement to be spread over the term of the arrangement.[84]

[105] A taxpayer must adopt a methodology to calculate income or expenditure over the term.[85] In respect of certain types of financial arrangements this is governed by "determination methods" identified by the Commissioner.[86]

[106] The Taxpayer must further calculate a base price adjustment on the maturity of the financial arrangement.[87] Such calculation is made by reference to a formula: consideration less income, expenditure and amount remitted.[88] Income is income derived under the financial arrangement;[89] expenditure is that which is incurred under the financial arrangement;[90] and an amount remitted is an amount that is remitted by the person or by law.[91] Consideration is "all consideration that has been paid and all consideration that is or will be payable, to the person for or under the financial arrangement".[92] But that definition is adjusted in "particular cases", where a more specific section applies.[93] In this case s EW 32 is more specific. It applies to agreements for the sale and purchase of property and services.[94] The value of the property or services is to be determined by "the lowest price the parties would have agreed on for the property or services, on the date the agreement … was entered into".[95]

[107] The optional convertible note in issue in this case is an example of a hybrid tax instrument. The reason that is so is explained in *The New Zealand Accrual Regime — A practical guide*, where the learned authors say:[96]

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84 Section EW 14(1).
85 Section EW 12.
86 Section EW 20.
87 Section EW 29(3).
88 Section EW 31(5).
89 Section EW 31(9).
90 Section EW 31(10).
91 Section EW 31(11).
92 Section EW 31(7).
93 Section EW 31(8).
94 Section EW 32(1).
95 Section EW 32(3). Note [20]–[21] above, where the parties agreed to the lowest price of the shares at the date the Note was executed.
96 Susan Glazebrook and others *The New Zealand Accrual Regime — A practical guide* (2nd ed, CCH, Auckland, 1999) at 199.

> In broad terms, a convertible note can be considered to be a debt instrument which provides at least part of the return in the form of shares in a company or rights to subscribe for such shares. Such instruments have always been particularly difficult to bring within an income tax system which operates by drawing a distinction between the tax treatment of debt and equity. A convertible note is a hybrid instrument: it is part equity and part debt. To the extent to which the convertible note offers note holders a share option or a right to shares, the note is an equity instrument. To the extent to which the note offers coupon interest returns and/or a cash redemption option, it is a normal debt instrument. … The hybrid nature of a convertible note means that it is appropriate to treat the note neither as a debt instrument nor as an equity instrument.

[108] It is inherent in the final sentence of that passage that if taxed under the ordinary provisions, "some part of the hybrid instrument is being taxed in a way in which it should not be taxed."[97] To avoid the potential issues that may result, the Commissioner has issued determinations that relate specifically to convertible notes.

[109] The Commissioner's power to issue determinations is contained in pt 5 of the TAA. Determinations are made under s 90 of that Act and apply in principle to a financial arrangement until a new determination relevant to that arrangement is made.[98] The Commissioner may determine, inter alia, the method to be applied in the determination of income derived or expenditure incurred under the financial arrangements rules, or, for example, how certain values are to be determined under contracts for property.[99]

[110] For the purposes of taxing convertible notes there are two relevant determinations: Determination G22 (optional convertible notes) and Determination G5C (mandatory convertible notes). The need for two different approaches is explained in *The New Zealand Accrual Regime — A practical guide*:[100]

> For the purposes of applying the accrual rules to convertible notes, a distinction has to be drawn between notes where conversion into shares is mandatory and notes where it is optional. The distinction is important because, with mandatory convertible notes, the equity component of the note is an agreement to purchase shares. An agreement to purchase shares is not an excepted financial arrangement (unless it falls within the definition of a short-

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97 Joanna Khoo "Line in the Sand of the Debt/Derivative Desert: The Tax Treatment of Optional Convertible Notes" (2011) 17 NZJTLP 209 at 210.

98 Tax Administration Act 1994, s 90AA(1).

99 Section 90AC(1).

100 Glazebrook and others *The New Zealand Accrual Regime — A practical guide* (2nd ed, CCH, Auckland, 1999) at 200.

> term agreement for sale and purchase of property); the agreement itself is a financial arrangement. An alternative is that a mandatory convertible note can be viewed as a loan which is repaid in shares — again, not an excepted financial arrangement. On the other hand, with respect to optional conversion convertible notes, the equity component is an option to acquire shares which, as noted at [902], will in general be an excepted financial arrangement.

[111] In FHNZ's submission, it is irrelevant which of the two determinations applied to the subject transaction — because both provided for full deductibility of the $66 million paid. To the extent it is germane, I consider determination G22 applied.[101]

[112] The explanation to Determination G22 (which does not form part of the determination itself) states:

> This determination applies to those optional conversion Convertible Notes where conversion into company shares is at the option of the holder and the convertible note is denominated in New Zealand dollars.

[113] This passage summarises in brief terms the section of the determination addressing its scope[102] (which is binding). In this case, the probabilities of DBNZ choosing not to exercise its option do not, in my view, change the fact the conversion was, on the document itself, "at the option of the holder". The Commissioner did not argue to the contrary.

[114] In its terms Determination G22 sets out the method for apportioning the part of the acquisition price of the note attributable to the option to buy shares. It also sets out what amounts are not included in calculating income or expenditure, how the base price adjustment is to be calculated and certain principles relating to consideration under the base price adjustment. As the Court of Appeal explained in *Alesco New Zealand Ltd v Commissioner of Inland Revenue*, where the taxpayer issued such a note (in that case with a zero coupon):[103]

> The OCNs are a financial arrangement. G22 is no more than the Commissioner's prescription for severing and calculating the amount of Alesco NZ's obligation attributable to the excepted financial arrangement – that is the equity element of the OCNs constituted by the share option. Its legal status and effect is limited to providing the appropriate methodology for that

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[101] Determination G22 was later replaced by Determination G22A. The parties also referred to the latter determination and I will do so to the extent relevant.

[102] Section 3.

[103] *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 145 at [78].

> purpose. It is not determinative of the underlying question of whether notional interest deductions claimed on the debt component of the instrument amount to "expenditure" or "expenditure incurred" in terms of the financial arrangements rules.

[115] As to the wider purpose of the financial arrangements rules, Lord Hoffmann, delivering the Board's advice in *Commissioner of Inland Revenue v Auckland Harbour Board*, outlined the regime in the following way:[104]

> This innovative system was introduced in 1986. It has two main features: first, in principle and subject to exceptions, it taxes the entire yield from a financial arrangement without regard to whether it is income or capital. Secondly, it deems that yield to be receivable over the expected life of the arrangement. In its simplest form, it requires the whole of the expected cash return from the arrangement to be calculated, the acquisition price deducted, and the difference treated as taxable income which will be received evenly over the tax years until maturity. Mr McKay, who appeared for AHB, pointed out that this approach required one to discard traditional and intuitive reactions based upon the principle that income tax is a tax on income. As Glazebrook and Oliver say in their book, *The New Zealand Accrual Regime* (1989) at para 301:
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> > "[The traditional] legal/accounting approach to defining what constitutes income can be compared with an economic approach. Under economic principles all gains in wealth are generally considered to be 'income' and all reductions in wealth are subtracted from income. Whether any 'gain' or 'loss' can be categorised as capital or revenue assumes no relevance, the only issue is whether there is an overall gain or loss of wealth over the period for which the income is being measured.
> >
> > The accrual regime can be interpreted as a fundamental shift from the rest of the income tax regime which operates on traditional legal/accounting principles. It is a move to a regime where the Act operates more on economic principles."

[116] Those observations about the economic approach under the financial arrangements rules are echoed in the Court of Appeal's judgment in *Alesco*. After reviewing the rules and the Commissioner's power to issue determinations, the Court stated:[105]

> [71] In our judgment, the financial arrangements rules were intended to give effect to the reality of income and expenditure – that is, real economic benefits and costs. They were designed to recognise the economic effect of a transaction, not its legal or accounting form or treatment. The question is whether the taxpayer has "truly incurred the cost as intended by Parliament". This construction is reinforced by the relevant addition, in three critical

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104 *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (PC) at [2].

105 *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 145.

> provisions, of the word "incurred". In the *Mitsubishi Motors* case the Privy Council affirmed, with reference to an earlier statutory provision, that expenditure is incurred on the premise that it arises pursuant to a legal obligation.
>
> [72] These features suggest that Parliament did not intend that a taxpayer would be entitled to use the financial arrangements rules as a basis for claiming deductions for interest for which the taxpayer was not liable or did not pay. The rules were intended to operate as a net regime – that is to bring to tax the amount yielded after deducting the entire economic cost from a taxpayer's entire economic benefit. In the absence of a liability a taxpayer claiming the benefit of a deduction for interest payments would be purporting to incur that liability without suffering the economic burden. We are satisfied that the intended purview of the rules is to exclude notional transactions.

The wider quest for legislative intention — the group approach

[117] As explained in *Ben Nevis*, the question of whether a particular application of specific rules is consistent with Parliament's purpose requires that the scope of such rules be considered within the *overall* scheme of the Act.[106]

[118] The subject transaction had cross-border features which the Commissioner identifies (particularly in the first theory she advances) as involving funding between an offshore parent and a New Zealand subsidiary. In her second theory, equivalent offshore funding is seen as reducing DBNZ's real economic exposure to $55 million, in respect of which FHNZ's position should, on her approach, be seen as the reflex.

[119] Three specific aspects of New Zealand's international tax regime warrant mention at this point:

(a) The imposition of NRWT on dividend, interest and royalty flows

[120] New Zealand is and has been for many years a net importer of capital, returns on which typically take the form of dividend, interest or royalties. The imposition of NRWT allows New Zealand to derive tax revenues from such returns. The rate at which NRWT is imposed is, in turn, often dictated by relevant Double Taxation Agreements between New Zealand and another jurisdiction. NRWT is an important mechanism to tax income streams as they leave New Zealand.

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[106] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at 108.

[121] NRWT is imposed where a person derives non-resident withholding income, the definition of which is premised on the person not being resident in New Zealand.[107] I accept the submission of FHNZ that the NRWT regime is premised on the separate tax treatment of related group entities and eschews a consolidated or group approach. NRWT would not and could not be applied if payments of interest, dividends and royalties between a New Zealand subsidiary and offshore group member did not have separate recognition for tax purposes.

[122] Indeed, the separate entity principle is so fundamental as a base protection measure that it is imposed on a single entity operating in two or more jurisdictions including New Zealand (as, for example, through a New Zealand branch office). So, in the present case, DBNZ, the New Zealand branch of Deutsche Bank AG, would be treated as having separate entity status for taxation purposes.

(b) The transfer pricing regime

[123] New Zealand domestic law also contains transfer pricing principles to ensure transfers between related entities (including by way of debt) occur on an arm's length basis. The relevant provisions are now in ss GC 6–GC 14 of the Income Tax Act 2007.[108] Section GC 6(1) describes the purposes of these provisions as being:

> To substitute an arm's length consideration in the calculation of a person's net income if the person's net income is reduced by the terms of a cross-border arrangement with an associated person for the acquisition or supply of goods, services, or anything else.

[124] Accordingly, mirror provisions[109] provide that if the amount of consideration paid by a New Zealand entity is more or less than an arm's length amount, an amount equal to the arm's length amount is treated as the amount payable by the taxpayer for the purposes of calculating their income tax liability for the relevant tax year.

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[107] Income Tax Act 2004, s NG 2.

[108] See s GD 13 of the Income Tax Act 1994 and s GD 13 of the 2004 Act. I am satisfied that Parliament's intention under those Acts was identical, for the purpose of the issues I am examining, to that under the 2007 Act provisions.

[109] Income Tax Act 2007, ss GC 7 and GC 8.

[125] The broad policy of these provisions is confirmed by the Commissioner's Transfer Pricing Guidelines (TPGs) issued in 2000 which, among other things, provide the following high level comments in respect of the operation of the regime:[110]

> **Key Points**
>
> …
>
> - The focus of New Zealand's transfer pricing rules is to ensure that the proper amount of income derived by a multinational is attributed to its New Zealand operations…
>
> - New Zealand has adopted the arm's length principle because it is considered the most reliable way to determine the amount of income properly attributable to a mulitnational's New Zealand operations and, because it represents the international norm it should minimise the potential for double taxation.

[126] The TPGs continue by recognising the wider advantages of the regime:[111]

> 64. The arm's length principle also results in a broad parity of tax treatment for multinationals and independent enterprises. This avoids the creation of tax advantages or disadvantages which would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm's length principle promotes the growth of international trade and investment.

[127] Again I accept FHNZ's argument that the arm's length principle underpinning the New Zealand transfer pricing rules is itself premised on a separate entity approach.[112]

(c) The thin capitalisation regime

[128] These rules, now in subpart FE of the Income Tax Act 2007,[113] apply in respect of debt-funded companies owned or controlled by non-residents so as to limit interest deductions in circumstances where prescribed debt equity ratios are exceeded. The ratio prescribed in the income years relevant to this proceeding was 75:25.[114]

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110 Inland Revenue Department "Transfer Pricing Guidelines" (2000) 12(10) *Tax Information Bulletin* at 9.

111 At 11.

112 The same approach also underpins the associated enterprises article of the OECD's Model Tax Convention on Income and on Capital which forms the basis of each of New Zealand's 40 double tax agreements.

113 See Income Tax Act 2004, sub-pt FG.

114 Section FG 3.

[129] Again, these rules assume individual-entity recognition in a multi-national group context and again I accept FHNZ's submission that, assuming a group approach, interest payments made by a New Zealand entity to an offshore equity would simply be disregarded with the result that the rules would be irrelevant.

The three regimes in a wider context

[130] Each of these three regimes is, as I have indicated, simply reflective of broader principles in the way New Zealand approaches the taxation of cross-border transactions. Professor Craig Elliffe captures that point early in his text *International and Cross-Border Taxation in New Zealand*:[115]

> Our current international tax system operates on the basis of attributing arm's-length profit to separate entities which either are resident in, or operate in, a jurisdiction. Many of the concepts of international tax drive off this principle that you can fairly and appropriately attribute profit to a particular entity. At some point in time in the future there may well be a concept of international tax under some form of unitary taxation or formulary apportionment rather than the current approach of separate entity accounting (the tax system respects separate legal identities for a multinational's subsidiaries in various countries). Under formulary apportionment a multinational entity doing business in several countries pays tax on a global basis which is subsequently apportioned, using a formula, to the various countries in which the business is operating.

[131] The position is taken up in more detail in subsequent sections of the Professor's text. On the issue of company tax residence he says:[116]

> The general definition of separate legal existence from its members is the key test of what constitutes a company. It is applied to foreign entities operating in New Zealand in order to determine whether they should be regarded as corporate taxpaying entities in their own right (opaque) or whether New Zealand taxation should occur at the level of the members/investors (transparent or look-through).

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[115] Craig Elliffe *International and Cross-Border Taxation in New Zealand* (2nd ed, Thomson Reuters, Wellington, 2018) at 3. Although the text is very recent the position was the same under the Income Tax Act 2004 — see ch 3 "The New Zealand International Tax Experience — A Brief History"..

[116] At 91. A company, is defined in the Act, as meaning "a body corporate or other entity that has a legal existence separate from its members, whether it is incorporated or created in New Zealand or elsewhere". The definition elsewhere contemplates taking a group-based approach but does so *only* for group investment funds (subject to specific tax rules). Non-residents are excluded from New Zealand consolidated groups with the result that the consolidated group regime has no application to the current proceedings. FHNZ submits that this exclusion further emphasises that New Zealand's international tax rules required the recognition, and "not the disregard", of transactions between New Zealand subsidiaries and their offshore group members.

[132] And in relation to the arms-length principle and the individual entity framework which underpins it he says:[117]

> OECD countries tax multinational enterprises (MNEs) on the basis of single entities (that is, even though there is a common economic ownership, each separate company has a separate and different legal persona which is subject to tax). When MNEs apply a separate entity approach to intragroup transactions, they may not be concerned about the profitability of those transactions in the sense that one MNE separate entity approach to intragroup transactions, they may not be concerned about the profitability of those transactions in the sense that one MNE separate entity's loss is another MNE separate entity's gain. The MNE, because it is the same legal and economic group, is somewhat ambivalent about the profitability of each separate entity – it is the overall group of companies and its profitability that is their concern. On the other hand, each country in which the separate entities are located are very concerned to identify a reasonable means of achieving a sensible and fair allocation of profitability for the entity in their jurisdiction. This is the fundamental problem that transfer pricing seeks to overcome: how can profits be shared equitably and the risk of unrelieved double taxation minimised?
>
> The OECD have taken the approach that in respect of intragroup transactions, separate entities must be taxed on the basis of an arm's length principle.

[133] I accept FHNZ's submission that, central to the Commissioner's case and to the expert evidence she called, is the proposition that the Arrangement should be examined in terms of its overall impact at a group or consolidated level looking at the net external position of entities under common control. The point is most clearly illustrated by Professor Evans's remark: "to me the company is the shareholders".[118] And I also accept FHNZ's submission that in a cross-border context there are strong indicators that this was not Parliament's intention.

[134] Although Mr Smith QC submitted that this was a mischaracterisation of the Commissioner's case, that she had assessed FHNZ as a stand-alone entity and that what FHNZ described as a "group approach" on the part of the Commissioner's experts was no more than an exposition of the commercial and economic effects of the Arrangement, the point he makes is in my view more semantic than real. The experts'

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117 At 849-850. Similar observations appear in Johannes Becker and others *Klaus Vogel on Double Taxation Conventions* (4th ed, Kluwer Law International, The Netherlands, 2015) at 594 and in the Preface to the 1995 OECD report entitled *Transfer Pricing Guidelines for Mulinational Enterprises and Tax Administrations* (OECD, Paris, 1995). The Guidelines in turn describe Article 9 of the Model Tax Convention on Income and on Capital (which directs that transactions entered into between associated enterprises that differ from those that would be entered into between independent parties are to be treated as having been entered on arm's length terms for profit allocation purposes) as the "authoritative statement of the arm's length principle".

118 See [73] above.

positions in relation to commercial and economic effects of the cash flows, rights and liabilities under the agreement were substantively founded in a group approach and the Commissioner's submissions were in turn firmly ground in their evidence. It is irrelevant in that context that only FHNZ has been the subject of an assessment by the Commissioner.

[135] That said, however, it is important to emphasise that my observations about the apparent inconsistency of the experts' group approach with Parliament's assumed intention are specific to the arrangement in issue.

What is the "Arrangement"?

[136] If the test is whether the impugned arrangement, viewed in a commercially and economically realistic way, makes use of the specific statutory provisions in a manner consistent with legislative purpose, what then is the arrangement?

[137] Professor Evans described it in narrow terms as comprising the Note, Forward Purchase, guarantees and fee arrangement. He excluded the associated borrowings and repayments. However, the statutory definition is broadly framed in terms:[119]

> **Arrangement** means an agreement, contract, plan, or understanding (whether enforceable or not), including all steps and transactions by which it is carried into effect.

[138] In *Ben Nevis* the Supreme Court held that "tax avoidance can be found in individual steps or, more often, in a combination of steps" and that "even if all of the steps in an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement."[120] And in *Westpac Banking Corp* Harrison J noted the importance of the Court inquiring "into the transaction as a whole" which involved a "wider inquiry" than that at stage 1 in the analysis (compliance with specific provisions).[121] Moreover, although the Supreme Court framed the test by reference to the "impugned arrangement" it is clear that the inquiry into whether application of specific provisions is consistent with legislative purpose is to be

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119 Income Tax Act 2004, s OB 1, definition of "arrangement".

120 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [105].

121 *Westpac Banking Corp v Commissioner of Inland Revenue* (2009) 23 NZTC 23,834 (HC) at [188].

considered "in the light of the arrangement as a whole"[122] not simply by reference to the impugned part or parts of an arrangement.

[139] In my view the mandate to consider the arrangement (however expansively or restrictively that word is interpreted), in a commercially and economically realistic way, requires reference to the full context in which it occurred and all associated steps in what might be called "the overall transaction".[123] As such I consider argument as to the exact limits of the definition arid and Professor Evans' attempt to minimise the significance of FHNZ's simultaneous repayment of capital and retirement of debt to be unduly restrictive. I do not intend to exclude any part of what I regard as an integrated transaction from the inquiry I must undertake.

Assessment in light of the Ben Nevis factors

[140] In *Ben Nevis* the Supreme Court posited a non-exclusive list of relevant factors in assessing whether the use of specific provisions falls outside their intended scope.[124] I have identified these in [93] above. Although the Court made it clear that the statute does not confine the Court's inquiry and although there is inevitably some overlap in the factors identified,[125] I consider each of them in turn.

The manner in which the Arrangement was carried out

[141] There are a number of relevant observations in this respect.

(a) The transaction involved real money flows. DAP borrowed the equivalent of NZD 89 million from BNPP, $149 million was paid in cash by DAP to DBNZ pursuant to the Forward Purchase Agreement, DBNZ advanced $204 million to FHNZ, FHNZ applied $144 million of that to repay advances from Danone Finance SA and repurchased

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[122] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [107].

[123] This focus on the economic reality of the "transaction" features in the Supreme Court's discussion of the Privy Council decision in *Challenge Corp Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (PC); refer *Ben Nevis* at [94].

[124] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [108].

[125] Particularly in terms of the manner in which the arrangement was carried out and examination of potential artificiality and contrivance.

(for $60 million) 400 of the shares held in it by DAP. Most significantly, FHNZ made actual payments of interest at 6.5 per cent of the face value of the note over its five-year term. As Professor Choudhry acknowledged all of this was "real money".

(b) One aspect of the transaction involved what the Commissioner identifies as a circularity — that is the repurchase of share capital from DAP and DAP's simultaneous[126] payment under the Forward Purchase (augmented by the advance it obtained from BNPP). I will consider this more fully in discussing whether there was artificiality or contrivance in the transaction (the sixth factor identified by the Supreme Court).

(c) The manner in which the face value of the Note was fixed and the Note was priced was unusual, at least in the context of what might be called orthodox convertible note transactions. I accept Professor Choudhry's evidence that the most common reason why a corporate will issue debt in this form will typically be to fund some form of expansion or investment and that the very particular sum of the Note ($204,421,565) is a strong indicator that the company's medium term corporate financing requirements did not drive its face value.

(d) Rather the evidence (and in particular an email from DBNZ's Mr Scott Burridge to Groupe Danone SA's Mr Pierre-Andre Terisse dated 7 March 2003) establishes that the amount of the Note was fixed by adding to the $149 million under the Forward Purchase, the present value of five years' worth of coupons calculated by reference to the five-year New Zealand Dollar swap rate.

(e) Moreover, because the issuer of the Note was the wholly-owned subsidiary of another entity there was no share price volatility to observe and thus no way that the market could price the embedded

[126] I use the term "simultaneous" in the sense that the transactions occurred on the same day. The precise timing was not in evidence, nor do I consider it significant in terms of the s BG 1 inquiry.

option in the bond having regard to its maturity date. Here the coupon on the Note was a market rate referenced to the New Zealand Dollar swap curve (which was reasonably volatile in March 2000 but approximately 6.20 per cent at the time of closing). Professor Choudhry stated in evidence, which was uncontested, that the spread of 30 basis points over the swap note "appears to be as expected for an A1/A^{+} rated borrower, which this bond represented in effect compared with other corporate bond issues in NZD at the time".[127] He expressed the further view that the coupon was "essentially what was required to generate bond coupon payments that aggregated to the five year amortising loan value of $55.42 million".

(f) However, I do not consider it correct to conclude that just because a particular instrument (for example, a convertible note) typically exhibits certain characteristics when new "debt" is being raised, the absence of such characteristics in the context of a related party refinancing or debt-equity adjustment can be regarded as a significant indicator of avoidance.

(g) So, for example, the fact that the pricing of a convertible note will, in the context of an open market transaction, typically reflect the investor's "volatility play" in respect of the issuer cannot in my view be elevated to the proposition that, when priced in some other way in the context of an "off-market transaction", the "manner in which the arrangement was carried out" or the "economic and commercial effect of [the documents and transactions]"[128] predicate avoidance. That would be to place convertible notes within a straightjacket of orthodoxy when there is no reason why they might not be used in a related party transaction (as they were in *Alesco* without criticism on that account alone).[129] And although the pricing may have been unorthodox in an

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127 Note that 0.1 per cent was in turn paid by DBNZ to Groupe Danone SA by way of guarantee fee.

128 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [108]. See also [122].

129 It was the taxpayer's attempt to take a deduction in respect of a zero-coupon note issued by a subsidiary to its parent which was rejected in that case.

open market context there is no suggestion that the rate was one artificially increased to maximise deductions.

(h) So too, although the very particular sum of the note and the way this was arrived at was undoubtedly unusual in the context of a typical open market convertible note transaction, I would hesitate before regarding this as itself an indicator of tax avoidance. The majority's focus in *Ben Nevis* is on structuring to "gain the benefit of the specific provision in an artificial or contrived way".[130] It is therefore on the relationship between the arrangement and tax outcomes, not whether particular aspects of the transaction may seem unorthodox (or even contrived) in some normative sense. So, in *Alesco* the Court of Appeal considered itself unpersuaded by evidence, again given by Professor Choudhry, that the OCN's issued in that case contained unusual or unorthodox terms when compared to arm's length norms, that the optional component of the OCN's served no commercial purpose as Alesco Corp already held 100 per cent of the shares in Alesco NZ and that the option component of the OCN was valueless.[131] Although in the High Court Heath J had considered this to be evidence of artificiality and contrivance in a *Ben Nevis* sense, the Court of Appeal dismissed the evidence as "of marginal assistance in determining the Commissioner's primary position".[132]

(i) Nevertheless, although the focus is on tax outcomes and not the form of the arrangement per se, form will often beg the question — "but why, if other than to achieve the tax outcomes?" In this case FHNZ answers that fundamental inquiry by reference to DAP's Singaporean tax position, as I discuss further in [165].

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130 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [108].

131 *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 145 at [53] and [57].

132 At [57].

(j) The manner in which the arrangement was carried out is also usefully benchmarked against possible alternative structures as identified by FHNZ in its submissions.[133] These included:

(i) FHNZ borrowing an additional $60 million under the Cash Management Agreement to achieve its desired debt/equity rebalancing.

(ii) DAP (or Danone Finance) lending $204 million to FHNZ for five years at 6.5 per cent either by way of interest-bearing debt or convertible note.

(iii) FHNZ issuing a convertible note to DBNZ on the same terms but without the Forward Purchase between DBNZ and DAP and DBNZ funding the $149 million Forward Purchase amount internally or from another bank or third party or by a loan from DAP or Danone Finance or by a sub-participation by a third party or Danone entity.

(k) In each of these cases, FHNZ submitted, in my view uncontroversially, that it would have been entitled to full interest deductibility (totalling $66 million in relation to alternatives (ii) and (iii) and calculated by reference to the relevant floating rate in respect of alternative (i)) and that s BG 1 could not realistically be invoked to counteract the transaction.[134]

(l) It further submitted and I accept that in respect of each of alternatives (i) and (ii) (and likewise (iii) with funding or sub-participation by a Danone entity) these alternative arrangements would have given rise to assessable interest in the hands of the relevant offshore Danone entity. By contrast, the distinguishing feature of the transaction entered into was that, although the same level of deduction was available in New

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133 Accepting, however, that whether other arrangements would have produced similar tax outcomes to the impugned arrangement will not be determinative.

134 A submission which the Commissioner did not challenge.

Zealand, the Forward Purchase provisions negated foreign-assessable income. And in a further submission which I accept, it says that avoidance of foreign tax is not "tax avoidance" for the purposes of s BG 1.[135]

(m) I accept therefore FHNZ's submission that full deductibility for interest paid by FHNZ is "an entirely normative New Zealand taxation outcome of related party or third-party debt funding" and that such outcome is not attributable to any feature of the arrangement that might be described as "unorthodox" or even "artificial or contrived". If direct financing by DAP (either by convertible note or vanilla interest-bearing debt) of the full $204 million would have resulted in full interest deductibility, the question must arise why DAP's indirect financing of $149 million of the $204 convertible note principal should be seen to reduce FHNZ's "real" borrowing amount to $55 million as the Commissioner claims.

(n) And these alternative funding models also serve to place in perspective the "group" approach adopted by Professors Evans and Choudhry and reflected in IFRS 10, because although a $204 million loan by DAP (whether vanilla or by means of convertible note) is simply netted off on a group basis, nevertheless the loan and interest would be recognised in full for New Zealand tax purposes. They have to be, to protect the New Zealand tax base.

The role of all the relevant parties and their relationship to the Taxpayer

[142] The respective roles of the parties and their relationship to FHNZ has been previously described and need not be repeated. The key feature for present purposes is that all relevant parties to the transaction, with the exception of DBNZ and DAP's

135 Such is authoritatively established by *Commissioner of Inland Revenue v Europa Oil (NZ) Limited* [1971] NZLR 641 (PC) at 556. It is also endorsed by the Commissioner in her interpretation statement: Public Rulings Unit, Office of the Chief Tax Counsel *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (IS13/01, 13 June 2013) at 544.

funder BNPP, were related. This includes FHNZ, DAP, Danone Finance SA and Groupe Danone SA.

[143] That feature is in itself unremarkable in the context of a refinancing and equity reduction. However, two facets in particular of DAP's role warrant closer attention and will be the subject of later discussion namely:

(a) the element of circularity previously referred to; and

(b) its ultimate receipt via the Forward Purchase of 1025 shares in FHNZ, a company which it had owned from the outset.

[144] The Commissioner submits that the Arrangement would not have been possible without DAP's participation and its relationship with the plaintiff. I accept that it is unlikely it would have been entered into in the absence of that feature. The shares were non-voting and although they carried dividend entitlements FHNZ had no history of declaring dividends. The Forward Purchase ensured that the ownership of FHNZ would remain unchanged,[136] consistent with the fact that, as noted in FHNZ's statement of position, "it was not DBNZ's business to acquire equity holdings in groups such as Danone" and DAP's intention that DBNZ simply be a conduit of the shares.

[145] DBNZ's role in the transaction was pivotal. It can fairly be described as its architect. For that it received a fee of $1.8 million. And I accept Professor Choudhry's evidence that this was not conventional corporate banking business in the sense that it was intended to generate a return on lending.

[146] There was of course a DBNZ lending component ($55 million) but its March 2003 transaction summary entitled "Project Falcon SCM Asia Pacific Post Signature Note" evidences that it did not anticipate a material funding gain on the transaction.[137]

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[136] A noted commercial driver for the Danone Group: see above n 20.

[137] The coupon receivables to DBNZ were passed through to DBNZ Treasury. DBNZ Treasury swapped an EUR deposit using a foreign exchange (FX) swap to convert NZD receivables into EUR receivables at Euribor minus seven basis points. In evidence, which I accept, Professor Choudhry said that this suggested a hedged transaction very close to Deutche Bank AG's average cost of funds "ergo no material funding gain on the transaction".

Rather this was what Professor Choudhry described as a transaction "generating a return through fees".

[147] There were also "soft" benefits to Deutsche Bank generally, given that it was customer advisory business which advanced relationships between it and the Danone Group. In an email sent by DBNZ's Mr Burridge to multiple Deutsche Bank addressees in Australia, the United Kingdom and Europe shortly after signing, he described the transaction as:

> … represent[ing] an innovative financing structure for the client which funds their recent acquisitions in New Zealand and as such should enhance the Deutsche franchise with Groupe Danone.

[148] A slightly unusual feature of DBNZ's role in the transaction was that it paid a guarantee fee to Groupe Danone SA. In evidence which I again accept, Professor Choudhry stated that banks that require a guarantee from a parent normally do not pay for the privilege of receiving it and that, if one is required, the parent will typically charge the subsidiary not the bank. Professor Choudhry was unable to "surmise why on this occasion DBNZ had to pay for its guarantee". I do not, however, consider that this aspect of the transaction impacts in any significant way on the s BG 1 analysis.

The economic and commercial effect of the documents

[149] The Commissioner says that although DBNZ paid the full amount of $204 million in cash for the purchase of the Note and that this payment was applied by FHNZ to replace initial acquisition funding, nevertheless the economic and commercial effects of this arrangement were not consistent with the legal form. She says that if the form of a transaction is contrary to or endeavours to recharacterise its economic substance then the case is not one where the taxpayer can be heard to say that they have simply chosen the most advantageous legitimate structure.[138]

[150] She says that "in reality" FHNZ received:

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[138] Relying for example on *Westpac Banking Corp v Commissioner of Inland Revenue* (2009) 23 NZTC 23,834 (HC) at [603].

(a) funding of $55.4 million from DBNZ on which it paid $11.09 million interest; and

(b) $149 million "from its parent via DBNZ as a conduit" which was repaid in a "costless exercise".

And she says that what was "in reality" the equity contribution gives rise to no interest or otherwise deductible cost.

[151] Put this way the Commissioner's approach doubles back on her initial theory as advanced in the statement of position, in terms of which DAP's payment under the Forward Purchase was recharacterised as an injection of capital represented by equity. Although that approach was rejected by the Adjudication Unit as taxation based on economic equivalence, it reappears as a reflection of "economic and commercial effect" premised on the seductive invitation to look at what was occurring "in reality".

[152] In its report the Adjudication Unit endeavours to draw a distinction between the proscribed and the permissible in the following terms:

> The approach to applying s BG 1 involves identifying the commercial reality and economic effects of the arrangement actually entered into. … Identifying the commercial reality and economic effects of the arrangement should not be confused within an approach that considers economic equivalence. Economic equivalence looks at identifying an arrangement that is economically equivalent to the arrangement entered into (such as an arrangement involving a $55 million advance to the Taxpayer from Deutsche Bank and a $149 million equity injection from [DAP] identified by the [Commissioner's Service Delivery Group] in this dispute.

[153] The difficulty from an analytical point of view is that if it is not possible to undertake the s BG 1 inquiry by inference to an economically equivalent arrangement (which I accept), why should it nevertheless be possible, under the pretext of considering the economic and commercial effect of the transaction to, in this case, regard DAP's $149 million forward purchase from DBNZ as a contemporaneous $149 million capital injection into its subsidiary at the commencement of the term? The prohibition on identification of an economically equivalent arrangement becomes, in that context, almost meaningless — a mere checkpoint for the Commissioner to divert

around, all the while maintaining the same recharacterisation argument. I have difficulty with that approach.

[154] Ultimately, however, the Commissioner's arguments in relation to economic and commercial effect reduce to a restatement of her overall position — that the transaction involved $55.4 million of debt and $66.5 million of principal and interest repayments, with the true "economic cost suffered" being $11.09 million only.

[155] It is correct that on a Danone Group basis this is exactly as the transaction was understood, including for accounting purposes. And it is correct, that from DBNZ's perspective it regarded itself as introducing $55.4 million of net funding for which its return of $11.09 million was largely offset by its funding costs, guarantee fees and the cost of the credit default swap it entered into.

[156] However, the Commissioner's approach presupposes, in the context of attempts first to divine parliamentary intention and then to benchmark against it, two propositions which are contentious. They are:

(a) The Arrangement is assessed in terms of its overall impact at a group or consolidated level looking (to the exclusion of the monies unarguably received and expended by FHNZ) at the net external position of entities under common control; and

(b) FHNZ does not incur a cost requiring tax recognition when it issues shares to satisfy its debt liability.

[157] The first of these has already been discussed. The second I will come to shortly.

Artificiality and contrivance

[158] The Commissioner argues, and I accept, that the presence of artificiality and contrivance can indicate that the Arrangement has been structured to align legal form with specific provisions in the Act and in a way which is not in fact reflective of the commercial and economic reality of the Arrangement. *Ben Nevis* recognises this

principle, although emphasising that the focus is on whether the taxpayer has "*gained the benefit*" of the specific provision in an artificial and contrived way and not simply whether, compared to arm's length norms, aspects of the transaction might be described as unorthodox or even artificial.[139]

[159] She says first that there were "some features of self-funding in the closely related cash flows of the Arrangement and other transactions closely connected with it".

[160] This is a reference to the share buy-back transaction which was effected with a portion ($60 million) of the Note issue proceeds. That sum was paid to DAP which, as part of the same transaction, paid $149 million to DBNZ under the Forward Purchase Agreement.

[161] FHNZ argues that any circularity was a function of the commercial goals which underpinned the transaction and that a reconfiguration of the debt/equity position of FHNZ could not be achieved in any other way. That is not the case. To take the simplest alternative, FHNZ could have sought further accommodation from Danone Finance under the Cash Management Agreement and applied the proceeds to a capital reduction.

[162] However, as Harrison J observed in *Westpac,* circularity in a tax avoidance context is a "catchphrase frequently cited but seldom enlightening".[140] In that case his Honour found that there was no circularity of the type indicative of a tax avoidance arrangement because the payments which had been made discharged a genuine contractual liability. Such can be contrasted with the paradigm case where the circular flows of money are such that the transactions are self-cancelling or where the circularity means that the economic outcomes claimed in support of (for example) a tax deduction are not in fact sustained.

[163] In my view, the element of circularity identified by the Commissioner does not materially advance her case. The payment by DAP to DBNZ discharged a genuine

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139 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [108].

140 *Westpac Banking Corp v Commissioner of Inland Revenue* (2009) 23 NZTC 23,834 (HC) at [580].

contractual liability. FHNZ's payment of part of DBNZ's investment to DAP had both a legitimate commercial purpose and resulted in a "real" change to FHNZ's funding structure. I do not see it in the category of "offensive" circularity.

[164] The Commissioner is also critical of how the face value of the Note was determined and how it was priced. I have already referred to Professor Choudhry's evidence in this respect. I do not see this as evidence of "artificiality and contrivance" as such but I accept the unusually precise face value evidences that this was not a normal commercial funding arrangement and that the Note was priced as if it was a non-convertible instrument. In that sense, it was unorthodox.

[165] I accept also[141] that if a transaction is unusual that may be evidence of avoidance, but that is more typically so where there is no business reason for it to occur. So, for example, in *Ben Nevis* one of the reasons the arrangement was identified as unusual was that there was a real risk that it would not be profitable for subscribers.[142] By contrast, FHNZ says the business reasons for the Note transaction are obvious. It rebalanced debt/equity ratios in a way which retained NZ deductions broadly equivalent[143] to those under existing "vanilla" arrangements but without the same foreign tax exposure (French income tax). As Mr Marcello said in evidence, "vanilla financing doesn't achieve the intended purpose of the overall arrangement which is the non-inclusion of the recipient of the income". Significantly, the Commissioner did not challenge Mr Marcello's evidence that the difference between the $149 million paid by DAP to DBNZ at the commencement of the transaction and the face value of the shares received by DAP under the Forward Purchase would not be recognised as income in Singapore, whereas interest payable to Danone Finance under the Cash Management Agreement had been taxable in France.

[166] So when the Commissioner submits, as she does, that FHNZ provides "no compelling non-tax reasons" why:

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141 As does Professor Prebble in John Prebble *Fundamentals of Income Taxation* (Thomson Reuters, Wellington, 2018) at 410.

142 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [120].

143 See above n 22. The claimed deductions were approximately 20 per cent higher but on a higher total debt, reflecting the debt/equity rebalance.

(a) a convertible note was used when, by virtue of the Forward Purchase, DBNZ could not participate in any equity uplift;

(b) a Forward Purchase was used when DAP already owned all the shares in FHNZ; and

(c) why therefore the arrangement is said to be "contrived and artificial".

she ignores (or at least understates) "tax reasons" which featured in the calculus but are, in fact, legitimate aims that are not indicative of New Zealand tax avoidance.[144]

[167] The Commissioner also placed some emphasis when cross-examining Mr Marcello on the $1.8 million fee paid to DBNZ, for which it said "part of the reason … is a structure which delivers tax benefits in New Zealand isn't it?" This line of questioning was based on Professor Choudhry's evidence that the complexity of a structured finance transaction might drive a higher fee.

[168] I agree with Mr L McKay, however, that, on the evidence, this was a matter of conjecture and, in any event, the fee says nothing useful above whether the tax deductions arising under the arrangement were within Parliament's contemplation. Moreover, as Mr Marcello said:

> In my experience … working with tax advisors, the non-inclusion benefits of a debt financial structure is the reason for the higher fees. Not for the deduction of interest on debt. It is the non-inclusion of income to the recipient of the income stream versus the deductibility of the interest.

[169] In her statement of position, the Commissioner also alleged artificiality or contrivance on the basis that the option to settle the Convertible Note for cash was itself "artificial (in substance) and [DBNZ] never intended to exercise that option". That allegation is not maintained (at least as an indicator of artificiality) in the submissions in this case. However, she does say, with reference to her suggested inquiry into the economic and commercial effect of the documents and transactions, that the Forward Purchase changed the substance of the arrangement from optional to mandatory.

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[144] See above n 145.

[170] FHNZ does not dispute the likelihood that DBNZ would elect to settle the convertible note by way of conversion. Nor could it. Neither in conception nor execution was the agreement designed to deliver DBNZ as a long term shareholder. The provisions of cl 3.4 of the Forward Purchase whereby, in the event, DBNZ did not give a notice to FHNZ requiring the issue of shares on the maturity date, it was required to pay DAP not only the full value of the note, but a further amount reflecting what would in that situation be DAP's Singaporean tax liability on the difference between $149 million and $204 million, acted as a strong financial disincentive against the cash settlement option. More importantly, the commercial relationship between Groupe Danone SA and Deutsche Bank AG assumed a share "pass through" and DAP's ongoing 100 per cent ownership of its subsidiary.

[171] But that does not establish artificiality. There were clearly circumstances involving failure of FHNZ and its guarantor, where DBNZ's position as creditor may have been superior to that as shareholder. It is predictable that the Forward Purchase recognised such contingency by way of optional conversion, however remote it may have seemed. This was a substantial transaction. A full suite of protections was inevitable.

[172] I accept also FHNZ's argument that the optional or mandatory status of the Convertible Note is irrelevant to the core issue of the deductibility of the note coupon under the s BG 1 inquiry and that in such context the argument about whether it was, in substance, optional or mandatory takes the matter little further.

The Commissioner's "no cost" argument

[173] One of the central planks of the Commissioner's argument is that the shares issued by FHNZ to DBNZ in satisfaction of the Note were issued at "no cost to the taxpayer". The argument is summarised in the Commissioner's closing submission as follows:

> [192] The plaintiff incurred no real economic cost in issuing shares on maturity of the Note. The shares were not assets of the plaintiff and only come into existence on issue. Therefore, the plaintiff's property remained intact and its fiscal position unaltered. The only real or economic consequences to a share issue result from any dilutive effect on the existing shareholders' ownership in the issuer. The plaintiff gave up nothing from issuing the shares.

> The expert witnesses for the Commissioner confirmed there was no real or economic cost incurred by the plaintiff when it issued the 1025 shares.

[174] The Commissioner emphasises the point because it plays to her primary thesis that on a Danone Group basis FHNZ received only $55 million under the Note transaction which sum was repaid over the life of the Note.

[175] Mr McKay submitted this argument was unsound for a number of reasons which I summarise as follows:

(a) There is longstanding authority against the “no cost” proposition.

(b) The Commissioner’s argument is inconsistent with the approach adopted under the financial arrangements rules and in various Determinations relating to the discharge of debt by share issue. In none of these situations is the borrower treated as having paid no or inadequate consideration. Nor is debt remission income assessed, as would necessarily be the case if the Commissioner’s approach were correct.

(c) The proposition is unsupported on a counterfactual basis in that a share issue for debt conflates as a one-step transaction what could equally be two — payment for shares and use of the proceeds to repay the debt. In that case there would self-evidently be a cost associated with the repayment and, in FHNZ’s submission, such cost should be no less recognised for the set-off implicit in the one-step process.

(d) The “no cost” proposition cannot logically be confined to s BG 1 cases and would have far reaching negative implications if recognised generally within the tax context.

(e) It is not conceptually possible to have one rule for share issues to parent companies and another to third parties because the question is whether it is a cost to the company issuing the shares and the recipient is irrelevant in that context.

(f) In any event, there was an opportunity cost associated with the issue of the shares, which although they did not carry voting rights would inevitably have had value to the company if offered in the market — evidenced by the fact that when FHNZ was acquired by the Suntory Group (Suntory) it would never have contemplated the relevant parcel of shares not being included in the acquisition.

[176] In response, the Commissioner submitted that *Ben Nevis* mandates a focus on the economic and commercial effect of the transaction and that in reality there was no real expenditure or economic cost associated with the impugned part of the deductions.

[177] At the outset I agree with Mr L McKay that a focus on "cost" is capable of misdirecting the required analysis. "Cost" was undoubtedly relevant in *Alesco* where interest deductions were claimed in respect of what was in fact a zero coupon convertible note[145] but the underlying question in this case is not, fundamentally, whether the issue of shares had an economic cost to FHNZ but whether, as the law stood at the time, it was consistent with Parliament's intention that FHNZ should be able to deduct interest for a debt which (absent a Doomsday scenario) was always going to be repaid by the issue of shares which would themselves simultaneously be transferred to its parent. In principle a deduction might be consistent with Parliament's purpose even though one or more steps in the impugned transaction might not involve what the Commissioner calls "an economic cost". The injunction in *Ben Nevis* is simply to *look at the transaction* in an economically and commercially real way, unconstrained by the form the parties have used. However, as the Supreme Court also recognised, "the economic and commercial effect of documents and transactions *may* also be significant" (my emphasis).[146] It all comes back to a question of whether such effects assist in establishing that the relevant provision (in this case s DB 7) is (or is not) being used consistently with Parliament's purpose.

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[145] On the basis of deemed expenditure under Determination G22. Essentially what the taxpayer argued was that, by reference to the Determination, a notional value could be attributable to each of the debt and option components with a deduction available for the former. See *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 145 at [52] and [70]–[72].

[146] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [108].

[178] As to the cases, the usual starting point is Lord Greene MR's judgment in *Osborne v Steel Barrel Co Ltd* in which he rejected the proposition that the issue of 30,000 shares by the taxpayer did not form part of the consideration in a transaction related to the acquisition of trading stock.[147] The Commissioner had argued that, for taxation purposes, the value of the stock should be limited to the cash component of the transaction and that any uplift on that sum was therefore taxable. In that respect his Lordship said:

> The argument really rests on a misconception as to what happens when a company issues shares credited as fully paid for a consideration other than cash. The primary liability of an allottee of shares is to pay for them in cash; but, when shares are allotted credited as fully paid, this primary liability is satisfied by a consideration other than cash passing from the allottee. A company, therefore, when, in pursuance of such a transaction, it agrees to credit the shares as fully paid, is giving up what it otherwise would have had — namely, the right to call on the allottee for payment of the par value in cash. A company cannot issue £1,000 nominal worth of shares for stock of the market value of £500, since shares cannot be issued at a discount. Accordingly, when fully-paid shares are properly issued for a consideration other than cash, the consideration moving from the company must be at the least equal in value to the par value of the shares and must be based on an honest estimate by the directors of the value of the assets acquired.

[179] The same approach was adopted in the subsequent decisions of the Court of Appeal and House of Lords in *Craddock v Zevo Finance Ltd*[148] and it has since been followed in a number of Canadian authorities referred to by FHNZ.[149] In *Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd,* Lord Fraser summarised the position as follows:[150]

> (1) A company can issue their own shares "as consideration for the acquisition of property" — as Lord Greene MR said. (2) The value of consideration given in the form of fully paid shares allotted by a company is not the value of the shares allotted but, in the case of an honest and straightforward transaction, is the price upon which the parties agreed — as Lord Simonds said. The latter point was expressed even more forcibly in the House of Lords by Lord Wright where he said, 27 TC 267, 290: "No authority was cited for the claim of the Revenue in a case like this to go behind the *agreed consideration* and substitute a different figure."

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[147] *Osborne v Steel Barrel Co Ltd* [1942] 1 All ER 634 (CA).

[148] *Craddock v Zevo Finance Ltd* [1944] 1 All ER 566 (CA) at 570 per Lord Greene MR, McKinnon LJ concurring, Luxmoore LJ dissenting. An appeal was dismissed by the House of Lords.

[149] See for example *Tuxedo Holding Co Ltd v Minister of National Revenue* [1959] Ex CR 390, *King Rentals Ltd v R* (1995) 50 DTC 1132 (TCC); and *Teleglobe Inc v R* [2002] FCA 408.

[150] *Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd* [1983] 1 AC 501 (HL) at 511.

[180] Some of these cases occur in the context of a par or nominal value regime unlike that which now applies in New Zealand.[151] But they are, in my view, no less authoritative for that fact. As Lord Fraser's observations in *Stanton* make clear, in an honest and straightforward transaction it is what the parties agree was the consideration for the issue of the shares which counts in legal terms. Here the parties agreed on 14 March 2003 that the price of the shares was, for the purposes of the financial arrangements rules,[152] $204,421,565 and I see no reason to describe the transaction in the pejorative way necessary to exclude it from Lord Fraser's principle.

[181] However, none of the cases involved application of a general anti-avoidance rule or a share issue by subsidiary to parent. As *Ben Nevis* makes clear, the Courts are not limited in a s BG 1 context to "purely legal considerations".[153] Although the value of the shares might appropriately be recorded as $204 million, this does not preclude a finding that interest deductions on $149 million of that amount were, when the arrangement is looked at in a "commercially and economically realistic way", inconsistent with Parliament's purpose. Nor in that context does it matter whether the transaction is looked at as involving one step or two.

[182] For these reasons, although I consider the cases to provide helpful and important background, I do not regard them as ultimately decisive in terms of the inquiry I must undertake.[154]

[183] FHNZ's next and ultimately more compelling point is that the financial arrangements rules and the Determinations issued in respect of them all contemplate that shares may be issued in discharge of legal obligations and nowhere is a distinction drawn between a share issue to a parent (or in this case to an intermediate party which had contracted to transfer them to the parent) and one to an arm's length third party. From that Mr L McKay submits a strong inference arises that Parliament did not

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[151] Companies Act 1993, s 38.

[152] And in particular s EH 48(3)(a) of the Income Tax Act 1994; see above n 14.

[153] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [109].

[154] Including those cases relied on by the Commissioner on this point: *Lowry (Inspector of Taxes) v Consolidated African Selection Trust Ltd* [1940] AC 648 (HL); *Ord Forrest Pty Ltd v Federal Commissioner of Taxation* (1973-74) 130 CLR 124 at 131; *Pilmer v Duke Group Ltd (in liq)* (2001) 207 CLR 165; and *Commissioner for the South African Revenue Service v Labat Africa Ltd* (2013) (2) SA 33 (SCA).

consider this aspect of the transaction inconsistent with its purpose. Indeed he goes further and says the "costless" characterisation "cannot be reconciled with the financial arrangements rules' treatment of debt discharge through share issuance".

[184] In this context Determinations G5C and G22/22A are particularly relevant.

[185] Determination G5C relates to mandatory convertible notes. Several of the examples provided in it acknowledge a base price adjustment (a final "wash-up" calculation) upon termination of the arrangement and conversion of debt to shares. None contemplate any issue of debt remission income arising to the borrower on account of inadequacy of consideration on the share issue.

[186] Determinations G22 and G22A (which relate to optional convertible notes) are to similar effect and FHNZ makes the valid point that if the Commissioner's "costless" approach was correct a difference in approach could be expected depending on whether the note holder exercised the cash or conversion option. If the cash option, then a cost would be incurred in the form of the cash paid but, if the conversion option, there would be no cost and debt remission income would accrue. There is nothing in Determinations G22 or 22A, however, to suggest that remission income would arise in this event. In the broadly analogous circumstances of *Alesco*, the Commissioner made no such allegation. Nor did she challenge the effectiveness of the Alesco subsidiary satisfying the debt owed to its parent by way of share issue. The Court of Appeal accordingly made no suggestion that the liability could not be discharged in this way.

[187] As Mr McKay submits, if the issue of shares to satisfy a Note is to be regarded as economically costless then the issuing entity will have derived taxable debt remission income for the entire amount of the face value of the Note and this is highly unlikely to have been within Parliament's contemplation. Nor does *Alesco* suggest some special rule for Note transactions.

[188] Mr McKay also provided examples of three other regimes which he said implicitly recognised that Parliament cannot have intended that the absence of cost (in

the sense contended for by the Commissioner) on the issue of shares by a subsidiary to its parent changed taxation outcomes — namely:

(a) the revenue account property rules (which permit a deduction for the cost of revenue account property subject to tax on disposal);

(b) the depreciation rules (which permit depreciation deductions measured against the cost of the asset); and

(c) the trading stock rules (which determine an end of year deduction for the cost of trading stock acquired and not disposed of).

[189] He postulated the example of a parent selling property to its 100 per cent subsidiary at market value with the price satisfied by the issue of shares for a subscription amount equal to the value of the property (and with the mutual obligations offset). He then invited an assumption that the property was on revenue account, or was depreciable, or was trading stock. On the Commissioner's approach the property would have no cost base to the subsidiary which he submitted was "schematically and purposively untenable".

[190] I agree that it is difficult to envisage what gloss the Commissioner could introduce to her no-cost proposition to preclude that outcome. Either the issuance of shares is regarded by Parliament as sufficiently commercially and economically real to discharge debt liabilities or it is not. And all the pointers to parliamentary contemplation are that such commercial and economic reality is well recognised. Parliament's assumed intention is in that sense consistent with the common law position previously discussed.

[191] The financial arrangements rules provide an example. Assume an optional convertible note with a coupon rate of 6.5 per cent, issued by a New Zealand subsidiary to its 100 per cent offshore parent, in exchange for up-front funding. It may be satisfied by the issue of shares or repayment of cash. If by shares, the Commissioner's experts would say the debt had been satisfied at no economic cost to the subsidiary. Should that result in non-deductibility of the coupon payments? I can find no

suggestion in the financial arrangements rules that it would. Of course NRWT may be payable and, depending on the agreed value of the shares, there may be other "accrual" consequences. But the relevant issue is whether the economic cost of the share issue could affect the deduction for interest paid under the note. On my reading of the rules, it would not.

[192] Neither Determination G5C or G22 suggests that a parent-subsidiary relationship could affect the treatment of coupon interest payments.[155] Determination G22A does suggest that this relationship has a bearing on the financial arrangements as a whole. But it makes no mention of the effect of that relationship on the deductibility of interest. Rather, Determination G22A treats the consideration flowing between the parties as entirely attributable to the debt component of the note.[156] This provides an even stronger basis to suggest the interest payments would be deductible — as would be interest paid under a vanilla loan structure.

[193] I accept also Mr McKay's submission that, apart from constituting good consideration, the shares must be taken as having had real value. His observation in relation to the subsequent sale to Suntory is compelling in that context. And even with the restriction on voting rights it is inevitable that a price would have been achievable for them if offered in the market. In that sense the transactions also involved an opportunity cost to FHNZ. And there was always some commercial risk, however well managed, in issuing shares to an unrelated third party.

Was therefore s BG 1 appropriately invoked?

[194] I admit to finding application of the s BG 1 test difficult, as many judges before me have likewise done. Benchmarking against parliamentary intention, for all the appropriateness of the exercise, can be an elusive quest. Courts have an understandable resistance to structured transactions which may be seen to cost the

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[155] Determination G22 consistently excludes coupon interest payments from the excepted financial arrangement component of an optional convertible note – see cls 6(1) and (2), and 5(a). But the relationship between holder and issuer does not change this approach under the determination. Under Determination G5C, coupon interest payments are pro-rated to income years and this too is unchanged by the relationship between note holder and share issuer (see cl 4(4)).

[156] See cl 6(3) which states that for parties in a wholly-owned group, or with the same beneficial ownership or control, the equity component of an optional convertible notes is treated as zero.

New Zealand tax base but intuitive subjective assessments based on any such thought processes must themselves be firmly resisted.

[195] In my view, Parliament can be assumed, at a minimum, to have intended that the taxpayer could:

(a) Take a deduction for interest economically incurred;

(b) Deduct financial arrangements expenditure deemed to be incurred over the life of a financial arrangement;

(c) Account for tax on a separate entity basis, if the member of a multi-national group; and

(d) Issue shares to satisfy a liability owed to a third party, including its parent.

[196] It is also in my view tolerably clear that the grouped "economic" approach adopted by the Commissioner's expert witnesses is inconsistent with at least three specific aspects of New Zealand's international tax regime and more broadly the individual entity framework which underpins them. It is also selective because it ignores the fact that $89 million of the forward purchase amount was funded outside the Danone Group by BNPP.[157] Were the group approach to be accepted, it would be difficult to suggest that only internal transfers within the group should be assessed for tax purposes.

[197] In assessing whether the subject transaction crossed the line between permissible arrangement and tax avoidance arrangement I accept (adopting the legislative framework at the time) that:

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157 By way of example and of potential relevance to any reconstruction that an appellate court might be required to consider, prorating the $66 million of interest deductions by reference to the Danone Group's external lending position would suggest at least $46.5 million of interest may be deductible on a reconstructed basis.

(a) Parliament contemplated the use of OCN's and that the coupons on them, if calculated at an arm's length rate, will ordinarily be deductible;

(b) It was agnostic about the use of convertible note structures between parent and subsidiary.

[198] I accept as relevant also that other debt structures, incapable of realistic challenge under s BG 1, would have produced the same or similar tax benefits in New Zealand and that the particular appeal of DBNZ's structure was that it provided for non-assessibility of income in Singapore, albeit that the Arrangement delivered other benefits such as better balancing FHNZ's debt to equity position and creating a natural currency hedge. It was in that sense a transaction which assumed a status quo in terms of New Zealand deductibility but with significant added commercial advantages.

[199] What cannot be gainsaid is that the taxpayer received $204 million in cash from DBNZ. It was real money and it was expended. It attracted interest at 6.5 per cent which was incurred. Over the life of the Note, FHNZ's payments corresponded to that interest liability.

[200] The Commissioner adopts the grouped economic approach of her experts but the economic purity of their model drives a conclusion — that the Arrangement involved principal payment deductibility even in the context of cash settlement or novation — which raises significant questions about the utility of the model in predicating whether the transaction "crossed the line". And it is significant that Parliament should choose to define the limited circumstances in which a grouped approach applies and that this transaction is not among them. New Zealand's status as a net importer of capital would mean serious erosion of its revenue base if cross-border money flows between group members were routinely assessed on the basis predicated by the Commissioner's experts. Demonstrably that was not Parliament's intention.

[201] Likewise the "no cost" proposition, which underpinned the Commissioner's expert evidence and her submissions, does not in my view establish avoidance. Payment of cash by a parent to a subsidiary, for which the consideration is the issue of

additional shares, represents a routine commercial transaction. The consideration is real and has never been doubted as such. The financial arrangement rules, determinations and other aspects of the legislative and regulatory framework point to Parliament recognising the issue of shares by subsidiary to parent as economically real, irrespective of what the Commissioner calls "economic cost" to the subsidiary. This is the landscape on which the s BG 1 inquiry is necessarily imposed. Against the legislative background that existed at the time, there is, on account only of the method of repayment, simply nothing in my view to suggest non-deductibility of coupon payments on a MCN (or OCN on which the option was exercised) issued to an offshore parent by a New Zealand subsidiary. And if that is the case then it seems to me to be a long bow to suggest that the same method of repayment invokes a tax avoidance analysis in this case. If anything the interposition of DBNZ and the risk, however small, that it failed to on-transfer the shares elevates the case to a higher level of assumed conformity with parliamentary purpose.

[202] Nor am I persuaded that the "unorthodox" features of the Note identified by Professor Choudhry tip the analysis in the Commissioner's favour. I adopt the approach of the Court of Appeal in *Alesco* that these considerations are of "marginal assistance".[158] Parliament must be taken as recognising that related entities may use funding models which, within a different context, may exhibit other features. It cannot be assumed to stifle market activity to the extent I consider Professor Choudhry's evidence contemplates.

[203] This was a transaction which I consider had real and (from a New Zealand taxpayer perspective) legitimate economic drivers, primary among them offshore tax minimisation. It was self-evidently more "commercial" than the zero-coupon arrangements in *Alesco*. Interest was incurred by FHNZ both legally and, at a single-entity level, economically. And it was actually paid. The deduction did not depend on the taxpayer reverse engineering a deduction by application of the financial arrangement rules. Nor did the transaction involve back-to-back arrangements, each akin to the other, in the manner now typically assumed to infringe s BG 1.

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[158] *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 145 at [57].

[204] I conclude therefore that the section was not appropriately invoked by the Commissioner. In reaching that conclusion I note for completeness Mr L McKay's concession that as from 1 July 2018 the transaction is unlikely to satisfy the "black letter" of the 2007 Act, in light of *new* provisions introduced to counteract base erosion and profit shifting (BEPS).

In the alternative: was this merely incidental tax avoidance?

[205] I briefly address this issue on the assumption I am incorrect in my primary findings. FHNZ argues the "purpose or effect" of tax avoidance was "merely incidental". It relied on the following definition in the Act:[159]

> **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 purpose or effect is not merely incidental*
>
> (Emphasis added).

[206] In *Westpac*, Harrison J explained what was meant by "not merely incidental":[160]

> [W]hen used in conjunction with the word "incidental", I think the phrase "not merely" is designed to emphasise that a tax avoidance purpose, if found, will offend s BG 1 unless it naturally attaches or is subordinate or subsidiary to a concurrent legitimate purpose or effect, whether of a commercial or family nature. Identification of a business purpose will not immunise a transaction from scrutiny where tax avoidance can be viewed as "a significant or actuating purpose which ha[s] been pursued as a goal in itself": see *Tayles* per McMullin J at NZTC 61,318; NZLR 736. Conversely, a transaction will not offend where tax avoidance naturally attaches to that other acceptable purpose or effect.

[207] In *Ben Nevis*, although reliance had not been placed on the "merely incidental" exception, the majority observed it would "rarely be the case that the use of a specific

[159] Income Tax Act 2004, s OB 1, definition of "tax avoidance arrangement".
[160] *Westpac Banking Corp v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834 (HC) at [206].

provision in a manner which is outside parliamentary contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental."[161]

[208] FHNZ argued:

(a) The arrangement was motivated by legitimate commercial objectives: refinancing the New Zealand subsidiary and introducing local currency debt with a fixed rate of interest at a higher level.

(b) These objectives required deductions at (or over) the level achieved by the convertible note.

(c) The deductions achieved would have arisen whether the funding involved bank debt, related-party debt, a combination of the two, a hybrid instrument, or a vanilla loan repayable at the end of the funding term.

(d) As the deductions were a "constant" throughout, the use of the convertible note and DAP's role in the transaction can be explained by the Singaporean tax advantages of the arrangement.

(e) The New Zealand tax consequences were therefore merely incidental to the Singaporean tax advantages.

[209] Counsel submitted that a passage in the Commissioner's Interpretation Statement on tax avoidance is "clearly correct" where she says:[162]

> Under the merely incidental test, a non-tax avoidance purpose for the adoption of the particular specific structure may be relevant. Again, tax for this purpose is New Zealand tax, so avoidance of foreign tax would count as a non-tax avoidance purpose. If the New Zealand tax avoidance purpose or effect is merely incidental to a non-tax avoidance purpose, the arrangement is not a tax avoidance arrangement. As was explained, a tax avoidance purpose will be merely incidental if it follows as a natural incident from an arrangement structured a certain way for a non-tax avoidance purpose. *If it can be shown*

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161 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [114].

162 Public Rulings Unit, Office of the Chief Tax Counsel *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (IS13/01, 13 June 2013) at [545].

> *that a structure was put in place in the specific way it was to gain a tax advantage from another country, then it is possible that the New Zealand tax avoidance purpose follows as a natural concomitant.* If the New Zealand tax avoidance purpose is pursued as a goal in itself in any respect, however, the tax avoidance purpose will not be merely incidental.
>
> (Emphasis added).

[210] The Commissioner submits FHNZ's non-tax avoidance purposes could have been achieved in a simpler way. She argues unnecessary complexity in the transaction indicates the tax avoidance purpose was not merely incidental. The Commissioner also submitted that the Singaporean tax "benefit" was exaggerated by FHNZ — the absence of tax in one jurisdiction or another was "a given" and the transaction was primarily concerned with New Zealand deductibility. The features of artificiality and contrivance raised by the Commissioner in her submissions on the substance of the arrangement show, Mr Smith submitted, the purpose or effect was not merely incidental. The Commissioner said further the size of the tax benefit obtained means FHNZ was being *paid* to borrow. Taking advantage of the tax base to this extent could not have been merely incidental but must have been an independent driver of the arrangement.

[211] In some ways these competing arguments simply reflect the substantive arguments on the primary issue. As such they underscore the difficulty in saving an Arrangement under the "merely incidental" limb in circumstances where, ex hypothesi, it has already been found to use a specific tax provision in a way which is outside parliamentary contemplation. I have some sympathy with FHNZ's argument that domestic deductions were a "constant" and therefore a "concomitant" of the Singaporean tax advantages. But that is unsurprising given the conclusion I reach on the principal issue. Assuming a different conclusion, I am, perforce, also assuming at least one of the purposes or effects of the transaction was domestic tax avoidance. To then say that New Zealand deductibility was simply a "concomitant" of Singaporean non-assessibility would, as the Supreme Court suggested in *Ben Nevis*, appear to be a difficult argument. Ultimately however, I am not required to decide it.

Reconstruction — s GB 1

[212] In the course of the hearing the parties advised that, in the event I decided that the Arrangement was not a "tax avoidance arrangement" for the purposes of s BG 1, there would be no utility in my endeavouring to address how the Arrangement should be reconstructed on the assumption my conclusion was in error. I do not therefore take that aspect of the mutual submissions further.

In the alternative: would liability for penalties arise?

[213] The Commissioner considers FHNZ took an "abusive tax position" and assessed the taxpayer for shortfall penalties of $1,786,555 and $1,924,779 for the 2006 and 2007 income tax years respectively. My finding on the issue of tax avoidance has the effect of quashing these penalties. But had I reached the stage of assessing whether shortfall penalties were rightly imposed, I would have found they were not. My reasons follow.

[214] FHNZ is liable for a shortfall penalty if it took an "unacceptable tax position".[163] Taking an unacceptable tax position results in a 20 per cent penalty.[164] But if, viewed objectively, taking that unacceptable tax position was "with a dominant purpose of avoiding tax, whether directly or indirectly", the taxpayer will have taken an abusive tax position.[165] That results in a 100 per cent penalty.[166] As is the case here, previous good taxpayer behaviour can then reduce those penalties by half.[167]

[215] An unacceptable tax position is one that, viewed objectively, "fails to meet the standard of being about as likely as not to be correct."[168] That must be determined as at the time FHNZ took its tax positions[169] and the court must have regard to:[170]

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163 Tax Administration Act 1994, s 141B(2); the quantum of shortfall in this case satisfies para (a) and (b) of this section.
164 Section 141B(4).
165 Section 141D(7).
166 Section 141D(3).
167 Section 141FB.
168 Section 141B(1).
169 Section 141B(5).
170 Section 141B(7).

> (a) the actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and
>
> (b) decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to 1 month before the taxpayer takes the taxpayer's tax position).

[216] The "about as likely as not" standard does not require the taxpayer to show it "had a 50 per cent prospect of success" but rather that there was substantial merit in the taxpayer's argument.[171] Mr M McKay pointed to a select committee report on the Taxpayer Compliance, Penalties and Dispute Resolution Bill 1995, where the committee observed:[172]

> Officials advised us that "about as likely as not to be correct" means that a position does not have to be the correct position, or even have a 50 percent chance of success, but must be a position which would be seriously considered by a court.

[217] Mr M McKay argued the Commissioner's three theories about the arrangement — in his words comprising "multiple, and contradictory, positions" — illustrated FHNZ's contention was about as likely as not to be correct. The Commissioner rejected this characterisation saying that nothing could be read into her raising "alternative arguments" on the facts.

[218] I accept Mr McKay's submission that there were elements of inconsistency in the three different approaches. For example, assessing FHNZ for NRWT simply cannot be squared with theories challenging the deductions. This is favourable to the taxpayer insofar as it suggests difficulty in articulating a coherent theory which justifies description of the arrangement as tax avoidance. However it is not decisive. Whether the standard "about as likely as not to be correct" has been met involves an objective assessment. It must be made at the time the taxpayer's position was taken and cannot be answered solely by reference to later vacillations in the Commissioner's theory of the case.

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[171] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [184].

[172] Taxpayer Compliance, Penalties and Dispute Resolution Bill 1995 (119–2) (select committee report) at v.

[219] The relevant tax positions were taken on 24 July 2006 and 21 December 2007. The most authoritative statement on the relationship between avoidance provisions and other aspects of the Act (specifically, the accrual rules) at that time was the decision of the Privy Council in *Commissioner of Inland Revenue v Auckland Harbour Board*.[173] Lord Hoffmann, giving judgment of the Board, described the anti-avoidance rules as a "long stop".[174] His Lordship observed:

> [11] Their Lordships will return in due course to consider whether a base price adjustment on the basis of a transfer for a nil consideration is inconsistent with some fundamental principle of the accrual regime. But they should first draw attention to the fact that the Commissioner's argument involves putting s 64J(1) to a very unusual use. The section appears to Their Lordships to contemplate that the circumstances which justify its application will be specific to a particular transaction, arising out of the relationship between the parties and other relevant circumstances. In this respect it is similar to other anti-avoidance provisions such as s 99. Their Lordships do not of course suggest that the two sections necessarily cover the same ground, but what they have in common is that they are, generally speaking, aimed at transactions which in commercial terms fall within the charge to tax but have been, intentionally or otherwise, structured in such a way that on a purely juristic analysis they do not. This is what is meant by defeating the intention and application of the statute. Some of the work such provisions used to do has nowadays been taken over by the more realistic approach to the construction of taxing Acts exemplified by *(W T) Ramsay Ltd v Inland Revenue Commissioners* [1982] AC 300, although Their Lordships should not be taken as casting any doubt upon the usefulness of such tax avoidance provisions as a long stop for The Revenue.
>
> [12] In the present case, there is no tension between the commercial and juristic character of the transaction. It is, in legal, commercial or any other terms, a transfer of financial arrangements for no consideration. Such a transaction either attracts a deduction or it does not. The Commissioner accepts that it does, but claims the right under s 64J(1) to be able to amend the law to ensure that it does not. Their Lordships do not think that the section was intended to confer such a power. It would amount to the imposition of tax by administrative discretion instead of by law.

[220] The Commissioner argued that in the 2007 income tax year, the Court of Appeal in *Accent Management* had confirmed deductibility provisions "should only be invoked in relation to the incurring of real economic consequences of the type

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173 *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (PC).
174 At [11].

contemplated by the legislature when the rules were enacted."[175] Similar observations were drawn from earlier judgments.[176]

[221] But the inquiry is not with whether the taxpayer has *correctly* invoked the deductibility provisions. It is whether there is substantial merit in its arguments — that is whether they would be seriously considered by a court. FHNZ paid interest to DBNZ and claimed a deduction for it. Focusing on the "commercial and juristic character of the transaction",[177] there was a strong argument in the taxpayer's favour. For the reasons previously outlined, I also consider FHNZ was always credibly in a position to challenge the relevance of the economic analysis on which the Commissioner relied. I therefore consider that FHNZ did not take an unacceptable tax position. It is unnecessary in that context to consider whether the arrangement was abusive.

[222] In the result, if I am wrong in my principal conclusions I would have set aside the shortfall penalties.

Result

[223] In accordance with the relief sought in the statement of claim I:

(a) Declare that Commissioner's Assessments for the 2006 and 2007 income years are incorrect.

(b) Make orders pursuant to s 138P of the Tax Administration Act 1994 cancelling the Assessments.[178]

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175 *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21,323 (CA) at [126].

176 The English case of *Inland Revenue Commissioners v Willoughby* [1997] 1 WLR 1071 (HL) at 1079 per Lord Nolan; *Peterson v Commissioner of Inland Revenue* [2005] UKPC 5, [2006] 3 NZLR 433 at [45]; and *Challenge Corp Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA).

177 *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (PC) at [12].

178 Adopting the definition of "Assessments" in paragraph 77 of the statement of claim.

Costs

[224] Costs have not been addressed in submission. If FHNZ seeks to have these fixed at this stage then, in the absence of agreement as to quantum, memoranda (maximum five pages plus any supporting schedules) may be filed. Counsel are to confer to limit any areas of difference. Any submission, in opposition is to be filed within 14 days of the plaintiff's submission and any submission in reply within seven days thereof.

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Muir J