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Case Summary

Frucor Suntory New Zealand Limited v Commissioner of Inland Revenue [2018] NZHC 2860

November 2018

This case is the first win for taxpayers on a tax avoidance matter in nearly nine years. It represents a significant 'shot across the bow' to Inland Revenue's current approach to investigating corporate restructures and funding arrangements. We set out the facts below, followed by the highlights of the High Court's decision.

The facts

1 Frucor Holdings NZ ("Frucor") issued $204m of convertible notes to Deutsche Bank NZ ("DBNZ"), which carried interest at a rate of 6.5%pa, with a 5-year maturity. The terms of the note were such that in all but a "Doomsday" scenario, DBNZ would call for conversion to shares.

2 On the same day, Frucor's Singapore-based parent, DAP, entered into a forward agreement with DBNZ, under which DAP paid DBNZ $149m, and DBNZ would transfer the shares it received in Frucor on conversion to DAP. The effect was that the shares were immediately on-sold to Frucor's parent.

3 In the event that DBNZ did not call for the shares, it would pay to DAP $204m principal, plus $13.9m to reflect the tax that would then be imposed by Singapore on the difference between the $149m paid under the Forward Agreement, and the $204m received by DAP. (I.e. DAP would have $13.9m in income, if the shares were not converted, and they were paid $204m.)

4 Over its 5-year life, Frucor paid DBNZ $66m in interest paid on the $204m of convertible notes, which it deducted for tax purposes.

5 The Commissioner sought to conflate the two agreements, alleged tax avoidance, arguing that:

- The funding was essentially between parent and subsidiary, and DBNZ's real economic exposure was $55m only (being the balance of what the parent paid for the shares, and the convertible note face value), and the $66m nominally paid as interest on the note in fact represented repayment of the principal with $11m of interest only on the amortising debt (i.e. a grouped economic approach).
- The shares issued by Frucor to DBNZ were issued at no real cost to the taxpayer, because they were converted immediately to the taxpayer's parent, and the taxpayer gave up nothing from issuing the shares (i.e. nothing given and nothing gained).
- The arrangement was, therefore, artificial and contrived.

The judgment

1. Shares acquired by parent have "no economic cost" argument rejected

The Commissioner argued, as she has done many times before, that the shares issued by Frucor to DBNZ in satisfaction of the note were issued at "no cost to the taxpayer" (i.e. shares have no value when issued within a group context). The court concluded that position was unsound for a number of reasons, including:

— longstanding authority against the "no cost" proposition

— inconsistencies with the financial arrangement rules and various determinations relating to the discharge of debt by share issue

— illogical association of the "no cost" proposition with BG 1.

The court noted that the underlying question was not whether the issue of shares had an economic cost to Frucor, but, as the law stood at the time, whether it was consistent with Parliament's intention that Frucor should be able to deduct interest for a debt that was always going to be repaid by the issue of shares that would then be simultaneously transferred to the parent. The court concluded that Parliament can be assumed, at a minimum, to have intended that a taxpayer could:

— take a deduction for interest economically incurred

— deduct financial arrangements expenditure deemed to be incurred over the life of a financial arrangement

— account for tax on a separate entity basis, of the member of a multi-national group

— issue shares to satisfy a liability owed to a third party, including its parent.

We note that the payments made by Frucor were real, not notional, payments.

2. The grouped economic approach is incorrect

Central to the Commissioner's case and the expert evidence she called, was the proposition that the arrangement should be examined in terms of its overall impact at a group or consolidated level. The court noted that although "the "group" approach was mandated (and followed) a consolidated accounting level, such was the limit of its applicability". Frucor's own accounts were prepared on a "standalone basis" and therefore reflected the gross cash flows it received under the transactions.

The court also noted that in applying sections DB 7 and BG 1, the "group approach" was not intended by Parliament, finding the arguments put forward by the Commissioner and her expert advisers inconsistent in form and with at least three aspects of New Zealand's international tax regime; namely: Non-Resident Withholding Tax, Transfer Pricing and the Thin Capitalisation regime. The court accepted that in viewing the arrangement as a whole, the transactions that occurred between Frucor, DBNZ and DAP involved real money flows, including actual payments of interest.

3. Unorthodox and unusual transactions are not necessarily tax avoidance

The Commissioner argued that the notes did not pose usual and 'orthodox' characteristics. As the amount of the notes was not linked to some documented specific capital requirement in a rounded sum, rather its face value was "arrived at in what can only be described as an unorthodox and not market conventional fashion". Where by the face value of the bond was arrived at by working backwards from the coupon rate resulting in a principal amount described as being "a very exact number". The Commissioner argued that this was "not commonly how conventional bond issue notional amounts or convertible or otherwise are arrived at in the market". The unorthodox manner in which the note was priced therefore led back to the Commissioner's key conclusion that there was "no economic cost to FHNZ".

The court agreed that the manner in which the face value was fixed was unusual, but considered that it was not correct to conclude that just because a particular instrument (i.e. a convertible note) does not exhibit certain pricing characteristics, that the absence of such characteristics is regarded as a significant indicator of avoidance. The Commissioner argued that typically in the context of an open market transaction, the characteristics of pricing of a convertible note would reflect investors "volatility play" and priced in some other way in the context of an "off-market transaction", predicates avoidance.

The Judge concluded that although the pricing was unorthodox in an open market context, there was nothing to suggest that the rate was one artificially increased to maximise deductions.

4. A return of the "Choice Principle"?

Following the Supreme Court's decision in *Ben Nevis* the choice principle appeared to be dead in the water. The principle essentially says that Parliament could not have intended for taxpayers to be deprived of all tax beneficial choices and therefore to act in reliance of them is not to act in contravention of the law. In other words, if two options are available to a taxpayer as recognised in the law, the taxpayer may choose the one with the best tax outcome and to do so is not avoidance.

The court in *Frucor* noted "tax reasons" that feature in the calculus of a funding arrangement can, in fact, be legitimate aims and not indicative of tax avoidance. While not a "smoking gun" for the return of the choice principle, the statement by the court is a recognition that tax is a feature of decision making.

5. Counterfactuals

Contrary to Inland Revenue's Interpretation Statement on Tax Avoidance (which states the Commissioner's view that there is no need to identify a counterfactual (or alternative arrangement) in reaching a view on whether BG 1 applies), the court expressly considered other alternative funding arrangements that Frucor might have entered into. It concluded that the same deductions would have arisen in the alternatives indicating that the convertible note arrangement did not increase or artificially inflate the deductions.

6. Whether tax has been avoided overseas is not relavant to the New Zealand analysis

Frucor chose the convertible note structure because it gave rise to a $13m tax saving in Singapore, not because it could obtain interest deductions in New Zealand. In considering whether the structure was a tax avoidance arrangement, the court confirmed that the tax saving in Singapore is not a relevant factor.

Contact KPMG's Tax Dispute Resolution & Controversy Services team

If you have any questions about the above, please contact KPMG's Tax Dispute Resolution & Controversy Services team. In the first instance, contact Andrew Tringham at atringham@kpmg.co.nz or alternatively, Bruce Bernacchi at bbernacchi@kpmg.co.nz.

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