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WEEKLY COMMENT: WEDNESDAY 27 JUNE 2012

1. Inland Revenue recently released an exposure draft of Questions We've Been Asked on *Abusive tax position penalty and the anti-avoidance provision* – with a deadline for comment of 20 July 2012. The draft QWBA raises the very interesting question of when a tax avoidance purpose or effect that is *not merely incidental* would be regarded as a *dominant purpose* of avoiding tax.

2. In this *Weekly Comment* I discuss this issue in the context of three cross-border tax avoidance cases in recent years (none of which are discussed in the draft QWBA):

   - *BNZ Investments Limited & Ors v The Commissioner Of Inland Revenue* [2009] NZHC 822, (2009) 24 NZTC 23,582
   - *Westpac Banking Corporation v The Commissioner Of Inland Revenue* [2009] NZHC 1388, 24 NZTC 23,834
   - *Alesco New Zealand Ltd v Commissioner of Inland Revenue No. 2* [2011] NZHC 1750, (2011) 25 NZTC ¶20-099

3. In *Westpac*, the Commissioner argued that there was no commercial purpose. Harrison J rejected that argument. While the judge did not say so, there is an implication in *Westpac* that the tax avoidance purpose, while not merely incidental, was not judged to be the dominant purpose. In *Alesco*, however, the tax avoidance purpose was held to be the dominant purpose. The judgments are not easy to reconcile.

The draft QWBA

4. The question that is addressed is whether the 100% shortfall penalty for taking an "abusive tax position" under section 141D of the Tax Administration Act 1994 applies automatically if there is found to be a "tax avoidance arrangement" under section BG 1 of the Income Tax Act 2007.

5. The draft QWBA answers the question: No, the penalty does not apply automatically. The tests for a "tax avoidance arrangement" and an "abusive tax position" and are different:

   (a) A tax avoidance arrangement is:

      (i) An arrangement that has tax avoidance as its purpose or effect; or

      (ii) An arrangement that has tax avoidance as 1 of its purposes or effects, if the *tax avoidance purpose or effect is not merely incidental*.

   (b) An abusive tax position is a tax position that is an unacceptable tax position at the time it is taken, and that is taken, whether through an arrangement or not, with a *dominant purpose of avoiding tax*.

Purpose that is not merely incidental vs dominant purpose

6. It is noted in the draft QWBA that the Courts have recognised the need for there to be a dominant purpose of avoiding tax in order for an abusive tax position penalty to apply. Venning J in the High Court emphasised this in *Accent Management v CIR* (2005) 22 NZTC 19,027.

7. Therefore, where an arrangement has tax avoidance as 1 of its purposes or effects, and the tax avoidance purpose or effect is not merely incidental, the tax position taken will not be an abusive tax position unless the arrangement was entered into with a dominant purpose of avoiding tax.

8. The draft QWBA cites the meaning of "dominant purpose" discussed by Richardson J in the Court of Appeal in *CIR v National Distributors Ltd* (1989) 11 NZTC 6,346, at 6,350:

   "Adoption of a dominant purpose test in relation to the particular property purchased allows a sensible focus as a practical matter on what was truly important to the taxpayer at the time of the acquisition."

9. It is also noted that in *FCT v Spotless Services Limited & Anor* [1996] HCA 34, 96 ATC 5,201, the Full High Court of Australia defined "dominant purpose" as the ruling, prevailing, or most influential purpose.

Tax avoidance purpose more than merely incidental but not dominant

10. It is stated in paragraph 40 of the draft QWBA that:

    "In all cases where the relevant arrangement was held to give rise to an unacceptable tax position, the courts found a dominant purpose of avoiding tax. *There are no cases, therefore, that have found that the tax avoidance purpose or effect was more than merely incidental under s BG 1 but the purpose of avoiding tax was not dominant under s 141D*. As a result, there are no cases that Illustrate the circumstances where a tax avoidance purpose or effect is not merely incidental but the purpose of avoiding tax is not dominant." (emphasis added)

11. Whether there was an unacceptable tax position was not addressed in either the *Westpac* or the *BNZ Investments* cases. However, whether there was more than just a tax avoidance purpose of the arrangements and consequently, whether the tax avoidance purpose was more than merely incidental, was specifically addressed in *Westpac. BNZ Investments* was similar, but the discussion on the point was not quite as clear as it is in *Westpac*.

12. By contrast, in *Alesco* there was no examination of the relationship between the tax avoidance purpose and the other (commercial) purpose, which was to fund NZ acquisitions.

13. It is worth briefly reviewing the facts in these cases to see why *Alesco* warranted a penalty for an abusive tax position, while that was not argued in *Westpac* or *BNZ Investments*. In *BNZ Investments*, the form of the transactions was stated to have been developed by an "arranger of financial products". The identical nature of Westpac's transactions suggests the same thing in *Westpac*. The form of the transaction in *Alesco* was developed by KPMG Australia.

Westpac and *BNZ Investments* funding transactions

14. Both Westpac and the BNZ "lent" money to foreign special purpose subsidiaries (SPVs) of foreign parent company borrowers through buying shares from the SPVs under agreements that the shares would be sold back to the SPVs at a later time – say, 5 years.

15. In the period between purchase and sale, the banks received dividends on the shares. As the banks are foreign-owned, the dividends were exempt from NZ tax under the conduit tax regime.

16. The funds that were lent – i.e. the funds used to buy the shares – were obtained from depositors who were paid at a floating rate of interest. The exempt dividends received were at a fixed rate.

17. So, the banks hedged their interest rate exposure by entering into interest rate swaps with the foreign parties. They agreed to pay at a fixed interest rate and receive at a floating interest rate.

18. Both banks also paid the SPVs a fee to obtain a guarantee from the real borrowers (the parent companies of the SPVs). This was called a guarantee arrangement fee ("GAF") or a guarantee procurement fee ("GPF"). In essence this was a guarantee fee, but the banks wanted to ensure that NZ tax would not be payable under the non-resident general insurer's regime, so the documentation specified that the fee was for obtaining a guarantee, and not for the guarantee itself.

19. The transactions resulted in a NZ tax benefit for the banks due to tax deductions for the fixed interest payable under the swap and the GPFs. There was no taxable income: the income from the floating rates receivable under the swap was offset by the floating rates payable to the depositors, and the fixed dividends were exempt.

20. The dividends funded both the tax deductions – i.e. the dividends funded the fixed swap payments and the GPF. Due to the NZ tax benefit at the prevailing company tax rate of 33%, the dividends only needed to fund 67% of the tax deductions. The banks shared the NZ tax benefit with the foreign borrowers by setting the dividend rate so that the dividends funded 80.24% of the tax deductions.

21. [The tax benefit would have been shared equally – i.e. 50/50 – if the dividends had funded 83.5% of the tax deductions – i.e. 67% plus half of 33%. With the dividends set at only 80.24% of the tax deductions, the foreign parties enjoyed a slightly larger proportion of the NZ tax benefit.]

22. The foreign parties received fixed rate swap payments and the fixed rate GPF, and paid floating rate swap payments and fixed rate dividends. The share "repo" arrangement was treated as a loan in the foreign country, so all payments, including the dividend payments were tax deductible there.

23. The GPF was an essential part of the transactions, as it reduced the cost of the loan to the foreign party and, most significantly, allowed both the banks and the foreign parties to share in the NZ tax benefits. In essence, it turned a pre-tax loss for the banks into a post-tax gain. Expert witnesses for the Commissioner, whose evidence was accepted by the judges in both *Westpac* and *BNZ Investments,* stated that the GPF was unnecessary because it was highly unusual for the lender to pay the borrower a fee to guarantee repayments. It existed only to create a tax deduction in NZ.

24. The Commissioner disallowed the deductions for the GPF on the basis that:

    (a) The GPF was not deductible as "interest" under section DB 7 (which required no nexus with income) because it was not paid in relation to a financial arrangement; and

    (b) The GPF did not have the necessary nexus with income to be deductible under any other provision of the Act; and

    (c) Even if the GPF did have the necessary nexus with income, the deduction was disallowed under the general anti-avoidance provision, section BG 1.

25. The Commissioner disallowed the interest deductions relating to the fixed rate swap payments under the general anti-avoidance provision, section BG 1.

26. The transactions were held to be tax avoidance in both cases, and all deductions were disallowed. In addition, in *Westpac*, the GPF deduction was held to be unlawful under the specific provisions: the documentation stated the GPF was paid for a service – obtaining a guarantee – so it was not consideration paid on a financial arrangement, and it did not have the necessary nexus with income as the dividends were exempt income.

The *Alesco* transaction

27. Alesco NZ funded the purchase of a new business and the purchase of shares in a company with another new business by issuing optional convertible notes ("OCNs") to its parent company, Alesco Australia.

28. In New Zealand, under Determination G22, the OCNs consisted of debt and equity components: the amount repayable on maturity was discounted to the date of issue to determine the debt component, and the remainder of the issue price was attributed to the equity component. Alesco NZ claimed interest deductions under the financial arrangements rules for the interest capitalised each year, but no non-resident withholding tax ("NRWT") was payable.

29. In Australia, the OCNs were viewed as 100% equity instruments, so no interest income was returned by Alesco Australia.

30. The Commissioner disallowed Alesco NZ's interest deductions on the OCNs under the general anti-avoidance provision, section BG 1. In addition, the Commissioner alleged that an abusive tax position had been taken. Both of the Commissioner's allegations were upheld in the High Court.

31. The central feature of the arrangement in *Alesco* was the equity component of the initial advance. Over the term of the OCNs the equity component was converted into deductible interest, as the value of the options decreased to zero and the face value of the debt increased to the amount repayable at maturity. Expert witnesses for the Commissioner, whose evidence was accepted by the judge, stated that the option (equity) component had no value at the time of issue because Alesco Corporation already owned all the shares in Alesco NZ and did not intend selling the options before maturity. On that basis there would be no interest deductions.

Existence of a commercial purpose: *Westpac* vs *Alesco*

32. In *Westpac*, the Commissioner argued that the arrangements had no commercial purpose because there was no underlying commercial transaction. The transactions relied on favourable tax treatment for their very existence. Harrison J disagreed. He stated:

    "[590] I agree… that each transaction had a genuine commercial purpose. In my judgment the structural aspects, and in particular its taxation benefits, do not derogate from the existence of an objectively ascertainable commercial purpose. That purpose must be distinguished from the transaction's underlying commerciality or business viability. They are conceptually separate.

    [591] Westpac advanced substantial sums of money to overseas counterparties subject to an obligation to repay. The funding was linear, not circular, and the credit risk shifted from the bank to the economic borrower. Whether or not Westpac knew the particular use to which the other party intended to apply the funds is irrelevant."

33. By contrast, in *Alesco*, Heath J acknowledged Alesco NZ's need for funding, but held that the OCNs had no commercial purpose:

    "[107] … It was always intended that real money would flow from Alesco Corporation to Alesco NZ….

    [112] … No commercial purpose was served by Alesco NZ providing an option for Alesco Corporation to convert the debt into shares…"

34. There is a divergence between the approach of Heath J in *Alesco* and Harrison J in *Westpac*: in *Alesco*, using Harrison J's phraseology in *Westpac*, the structural aspects and the tax benefits did in fact derogate from the existence of the acknowledged commercial purpose: "that real money would flow from Alesco Corporation to Alesco NZ".

Tax avoidance purpose more than merely incidental

35. In *Westpac*, Harrison J stated:

    "[593] The question then is: did the transactions have a separate purpose of tax avoidance which was not merely incidental or subsidiary to the commercial purpose? The GPF is… the obvious focus….

    [594] I have found that Westpac unlawfully claimed deductions for the GPF…

    [595] … I am in no doubt that the GPF's function was to generate a statutory deduction for an expense which appeared genuine but was in truth a contrivance…"

    [617] … Westpac loaned funds to save taxes, not to achieve profits. I agree.. that, for the bank, the tax advantages came first and the transaction followed.

    [618] The tax avoidance purpose here could never be regarded "as a natural concomitant" of a dominant commercial purpose… As a matter of fact and degree, *Westpac's tax avoidance purpose was more than merely incidental* to any legitimate commercial purpose. (emphasis added)

36. Similarly, in *Alesco*, Heath J stated:

    "[93] The fact that the Notes were used to finance the acquisitions on the most tax effective terms means that *there can be no question in this case of tax advantages being derived on a merely "incidental" basis*. (emphasis added)

Tax avoidance purpose more than merely incidental and dominant

37. In *Westpac*, as noted in paragraph 32 above, Harrison J rejected the Commissioner's argument that the transactions had no commercial purpose. There followed an enquiry into whether the transactions had a separate purpose of tax avoidance which was more than merely incidental. As noted above, the tax avoidance purpose was not a natural concomitant of a dominant commercial purpose. However, *Harrison J stopped short of stating that the tax avoidance purpose was the dominant purpose*. In fact his rejection of the Commissioner's argument suggests that he implied that it was not the dominant purpose.

38. In *Alesco*, however, after finding that the tax advantages were not derived on a merely incidental basis, Heath J stated:

    "[110] … KPMG's offer to sell its own… structure to Alesco Corporation evidenced that *the dominant purpose of the structure was to procure New Zealand tax advantages*." (emphasis added)

Purpose of the arrangement

39. In deciding whether there is a dominant purpose of avoiding tax, it is noted in the draft QWBA that the majority in the Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, (2009) 24 NZTC 23,188 concluded that it was the *purpose of the arrangement* that was relevant to the enquiry as to whether there is an abusive tax position, and not the taxpayer's purpose.

40. Based on this, it is stated in paragraph 34 of the draft QWBA that:

    "If the specific features of the arrangement are mainly explicable by the tax purposes, then this would suggest that the dominant purpose is avoiding tax. If the specific features of the arrangement are mainly explicable by the non-tax purposes, then this would support the conclusion that the dominant purpose of the arrangement is not avoiding tax."

41. The Supreme Court's comments in *Ben Nevis* need to be read in the context of the arrangement in that case. In relation to that arrangement, the Supreme Court stated that:

    "[207] … it is the purpose of the arrangement itself, not the purpose in the mind of the taxpayer… the definition of an "abusive tax position" is concerned with the means employed rather than intentions of taxpayers in taking a tax position. The section requires that the arrangement itself be examined to ascertain its dominant purpose from its terms, irrespective of what may be known or inferred concerning the motives of individual investors."

42. The facts in *Ben Nevis* were significantly different from the cross-border tax arbitrage cases. The arrangement in that case appeared to have been devised for tax purposes without any real commercial purpose. The promissory note "was an artificial payment implemented for tax purposes" [147] and the insurance dimension was regarded as "both artificial and contrived" [148].

43. In *Westpac*, a separate commercial purpose was specifically acknowledged. It was in *Alesco* as well. However, the arrangements were structured so as to obtain the requisite tax benefits.

44. The important distinction in the *Westpac* and *BNZ Investments* cases was that lending was the commercial business of the banks, and the transactions did no more than structure lending in a way that resulted in tax benefits, using the available specific provision: the conduit tax regime. The arrangements had a commercial purpose.

45. Having said that, it is difficult to see how *Alesco* can be distinguished from *Westpac* and *BNZ Investments*. Real funds flowed from Australia to NZ, as Heath J acknowledged, but the structure was designed to result in tax benefits using available specific provisions: the financial arrangements rules and Determination G22.

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