DavidCo Limited
CHARTERED ACCOUNTANTS

Level 2, Shortland Chambers
70 Shortland Street, Auckland
PO Box 2380, Shortland Street
Auckland 1140
T +64 9 921 6885
F +64 9 921 6889
M +64 21 639 710
E arun.david@davidco.co.nz
W www.davidco.co.nz

WEEKLY COMMENT: FRIDAY 8 MARCH 2013

1. The Court of Appeal judgment in *Alesco New Zealand Limited v Commissioner of Inland Revenue* [2013] NZCA 40 was handed down on 5 March 2013. The decision was in favour of the Commissioner in all respects: the arrangement was tax avoidance, the Commissioner acted correctly in simply denying the interest deductions instead of considering the tax consequences of any alternative means of funding, and the arrangement warranted the penalty for abusive avoidance.

2. As in the High Court, the judgment focused on the second stage of the enquiry as set out by the Supreme Court in *Ben Nevis Forestry Ventures Ltd & Ors v C of IR; Accent Management Limited & Ors v C of IR* [2008] NZSC 115 (19 December 2008); (2009) 24 NZTC 23,188, being: whether the specific provisions have been used in a manner that is within Parliament's purpose and contemplation when the specific provisions were enacted, based on the commercial and economic outcome of the arrangement.

3. The first stage, whether the use made of the specific provisions was within their intended scope, was not disputed either in the High Court or the Court of Appeal. The Court of Appeal rather cryptically stated that "we have not considered that issue (i.e. the first stage) and do not express an opinion upon it".

4. In the High Court (in *Alesco New Zealand Ltd and Ors v Commissioner of Inland Revenue (No. 2)* [2011] NZHC 1750 (12 December 2011); HC AK CIV 2009-404-2145), Heath J made his decision based on the artificial nature of the debt instruments used, and his judgment that:

   "[113] … the terms of the subscription agreement were crafted to suit the tax advantages promised by the HINZ (Hybrid Into New Zealand) structure."

5. In contrast, the Court of Appeal held that the statutory tests for tax deductibility of the deemed interest component were not met. Alesco New Zealand Limited ("Alesco NZ") did not actually pay interest or suffer an analogous liability but obtained a reduction in liability to tax as if it had. The Court referred, at [71] when commenting on the "reality" of income and expenditure implicit in the financial arrangements rules, and again, at [83], to the Privy Council decision in *C of IR v Challenge Corporation* [1986] UKPC 45; (1986) 8 NZTC 5,219, where Lord Templeman compared the advantage gained by tax avoiders over other taxpayers as follows at p. 12:

   "In an arrangement of tax avoidance the financial position of the taxpayer is unaffected (save for the cost of devising and implementing the arrangement) and by the arrangement the taxpayer seeks to obtain a tax advantage without suffering that reduction in income, loss or

expenditure which other taxpayers suffer and which Parliament intended to be suffered by any taxpayer qualifying for a reduction in his liability to tax."

6. While they did not specifically say so, it appears to have been this principle of unfairness to other taxpayers that essentially drove the Court of Appeal's decision. Refer to the discussion in paragraphs 124 onward in the *Avoidance* section of this website for more on this point.

Nature of the funding transactions

7. Alesco NZ bought another New Zealand company and a New Zealand business in 2003: Biolab Ltd for $55m in January 2003 and the business of Robinson Industries Ltd for $28.653m in April 2003. Its parent company, Alesco Australia ("Alesco") wished to structure Alesco NZ's funding of both acquisitions in the most tax effective way. Alesco decided in February 2003 to use optional convertible notes ("OCNs"). OCNs to the amount of $78 million were issued by Alesco NZ to its parent.

8. The OCNs were short form instruments issued under an agreement which provided that:

   (a) Alesco NZ issued the notes at a price of $1 each to mature on a date 10 years from the date of issue.

   (b) No interest was payable on the notes.

   (c) On maturity Alesco would have the option of converting any or all of the notes into shares at the rate of one share per note, or of redeeming the notes for cash.

   (d) The notes were unsecured fully subordinated debt securities.

9. The Court of Appeal noted that in legal form and in economic substance Alesco made an interest-free loan of $78 million to Alesco NZ. The agreement provided for two alternative means of repayment:

   (a) On maturity of the notes in 10 years time, Alesco would be entitled to increase its shareholding in Alesco NZ from 100,000 shares to 78,100,000 shares; however the convertible option was of no practical value to Alesco given its total ownership of Alesco NZ; or

   (b) Redemption of the loan in cash in 10 years time.

10. The Court noted that adoption of the second course of action without any intervening right to interest would result in a significant economic costs or loss to Alesco. At the heart of the appeal was the question of whether Alesco NZ also suffered an economic cost commensurate with its claimed deductions.

Alesco NZ's tax treatment of the OCNs

11. Alesco NZ applied for accounting and taxation purposes the method prescribed by *Determination G22*, and:

   (a) Split the notes for revenue and accounting purposes into separate debt and equity components (without changing the terms and conditions of the loan instrument);

   (b) Calculated the present value of all the cash flows by reference to a discount rate, which was the yield for New Zealand government stock of a similar term (that is, for 10 years).

   (c) Treated the difference between the present value of the debt component ($38 million) and the cash redemption amount ($78 million) as the amount referable to the equity or

share option element ($40 million) and as "expenditure incurred" within the financial arrangements rules; and

(d) Treated the "expenditure incurred" as interest and deductible under the relevant statutory provisions.

What is the arrangement

12. It was common ground in the High Court that the notes themselves constituted the arrangement. However the arrangement is of wider ambit, as both Counsel accepted in the Court of Appeal: the arrangement includes all steps taken including the relevant funding instruments – the subscription agreement and the notes, the cash flows themselves, as well as all incidental steps taken by Alesco NZ to claim the tax advantages such as completing the income tax returns.

13. The Court of Appeal emphasised that the statutory arrangement is distinct from the underlying commercial transactions constituted by Alesco NZ's acquisition of the two other New Zealand companies. In other words, the "arrangement" did not include the business acquisitions. The focus was purely on the OCNs.

14. Counsel for Alesco NZ asserted that the business acquisitions were not driven by tax considerations and the OCNs were an intermediate step along a preordained commercial path. However the Court of Appeal noted that:

"[112] … this distinctive factor does not protect Alesco NZ. The question is whether the *particular* arrangement, regardless of whether it was the originating or intermediate step, had the purpose or effect of tax avoidance. A structure whereby the parent provided funding to its subsidiary of $78 million for 10 years on an interest-free basis, in exchange for the subsidiary issuing to it optional convertible notes, cannot possibly have been chosen for a predominantly commercial purpose. …

[113] There is only one available inference: Alesco adopted the OCN's solely in pursuit of the goal of tax avoidance… Nor was the benefit merely incidental to an underlying commercial purpose or effect; it was the only identifiable purpose and effect *of adopting the OCN structure*. We are satisfied that, but for that benefit, the OCN structure would not have been chosen. …" (emphasis added)

The essence of the decision

15. In the High Court Heath J was satisfied that Alesco NZ's sole motivation was to employ the most tax effect of structure. Therefore the arrangement was necessarily one that relieved the company from liability to income tax. The Court of Appeal disagreed with this approach:

"[28] … This approach, was, with respect, in error. The enquiry must be confined to the contractual instruments – the subscription agreement and notes – and the effect achieved by Alesco NZ's use of the financial arrangements rules and G22."

16. The Court of Appeal stated that the one decisive question is as follows:

"[56] … if it is established that Alesco NZ did not incur either a legal liability to pay interest or any economic cost of the loan, did its use of the financial arrangements rules and G22 to claim income tax deductions for expenditure incurred fall outside Parliament's contemplation when enacting the rules? Or expressed slightly differently, did Alesco NZ obtain a tax advantage without bearing the interest expense which Parliament intended to

be suffered in order to fall within the deductibility provisions? Or expressed differently again, should the anti-avoidance provisions be applied in a way which ignores the economic reality of the OCNs as contemplated by the deductibility provisions and G22?"

17. In the High Court, Heath J accepted the Commissioner's argument that the use of the OCNs was artificial and contrived because they were not the subject of negotiation and contained unusual unorthodox terms. However the Court of Appeal agreed with Counsel for Alesco NZ that such an examination was of marginal assistance. Therefore, it was not necessary for the Court of Appeal to consider whether the option component of the notes had any economic value. Instead, they chose to address Alesco NZ's challenge by separate reference to each of Alesco NZ's Counsel's arguments.

18. The argument on which the decision turned related to the use of *Determination G22*. The Court of Appeal noted that the statutory genesis of *G22* is found in s. 90(1)(g) of the *Tax Administration Act 1994*, which authorises the Commissioner to issue a determination about the method for determining that part of the expenditure which is attributable to an excepted financial arrangement. The Court stated:

    "[62] … Significantly, the Commissioner's power is to be exercised for the purpose of the financial arrangements rules. It is ancillary or confined to that purpose and the terms of a determination such as G22 must be construed within that particular context.

    [63] Our enquiry must therefore start with an assessment of the purpose so intended scope of the financial arrangements rules upon which Alesco NZ relied to claim interest deductions for expenditure incurred."

19. The Court reviewed the relevant legislation (in the *Income Tax Act 1994* and the *Income Tax Act 2004*) and emphasised these particular points:

    (a) Section EH 20, which sets out the purpose of the financial arrangements states that the purpose is to "accrue over the term of the arrangement… expenditure incurred".

    (b) Interest is defined in section OB 1 as "… means every payment… whether periodical or not and however described or computed…"

    (c) Section BD 2 allows deductions for: "… an expenditure… incurred by the taxpayer…".

    (d) Section DD 1 which denies certain deductions states that there will be no deduction for "interest… except so far as… it is payable… expenditure incurred under the accrual rules is treated as interest payable… expenditure on interest is an allowable deduction of a company…".

20. The Court noted that the concepts of "expenditure" or "expenditure incurred" are central to determining whether a particular funding transaction falls within the purview of the financial arrangements rules. The phrase is not defined in the financial arrangements rules. On its plain meaning within its statutory context the word "expenditure" requires an actual outflow of or parting with money on obligation to make payment. (The Court recognised that in other tax contexts such as depreciation a cash cost is not necessary to recognise an expense.)

21. The financial arrangements rules were designed to recognise the economic effect of a transaction. The question is whether the taxpayer has "truly incurred the cost as intended by Parliament". This construction is reinforced by the relevant addition in the three critical provisions referred to above (sections EH 20, BD 2 and DD 1) of the word "incurred".

22. The Court of Appeal held that 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 interest deductions for which the taxpayer was not liable or did not pay. The Court was satisfied that the intended purview of the rules is to exclude notional transactions.

23. *Determination G22* must be considered within the framework of the Court of Appeal's conclusion that parliament introduced the financial arrangements rules for the purpose of allowing income tax deductions for real economic costs incurred. It is essentially a prescriptive instrument to provide a method or mechanism for allocating liabilities. *G22*'s explanatory introduction supports this.

24. *G22* is no more than the Commissioner's prescription for severing and calculating the amount of Alesco NZ's obligation attributable to the equity element of the OCNs constituted by the share option. It's legal status and effect is limited to providing the appropriate methodology for that purpose. It is not determinative of the underlying question of whether notional interest deductions claimed on the debt component of the instrument amounts to "expenditure" or "expenditure incurred" in terms of the financial arrangements rules.

25. The Court stated that Alesco NZ's Counsel's argument:

> "[82] … always returns to the same essential starting point – that G22 transforms the fiscal effect of the absence of an obligation to pay interest to a real economic costs incurred by Alesco NZ on these notes of $40 million. However, something more would be necessary to persuade us that words can turn a negative into a positive or a pretence into a reality…. G22 speaks for itself …
>
> [83] In summary, to paraphrase what was said by Lord Templeman in *Challenge* and adapted by the Supreme Court in *Penny and Hooper v C of IR* [2011] NZSC 95; (2011) 25 NZTC 20-073, Alesco NZ did not actually pay interest or suffer an analagous liability but obtained a reduction in liability to tax as if it had. … Alesco NZ did not as a matter of fact incur an expenditure or a liability for (interest) within the meaning of s DD 1 of the Act."

Reconstruction and penalties

26. The Court held that the terms of section GB 1 are plain. The Commissioner "may have regard to" an alternative funding arrangement, but she is not bound to take that step, and nor should she be where the tax advantage can be counteracted simply by disallowing the implement impermissible deductions. The appropriate comparison was available within the available tax treatments of the OCNs.

27. The Commissioner is also entitled to confine herself solely to negating the benefit. As the Court of Appeal stated in *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21,323:

> "[155] … There is thus no need for the Commissioner (or Court) to conjure up an alternative and more effective scheme into which the taxpayers might have entered."

28. The Court of Appeal agreed with Counsel for the Commissioner that a reconstruction based upon an interest-bearing loan would have two unacceptable consequences:

    (a) One would be a failure to counteract the tax advantage obtained by Alesco NZ's use of the OCNs.

(b) The other would be to allow the company to secure an increased tax advantage in the form of greater deductions, which would be perverse, enabling Alesco NZ to benefit from the consequences of its own unlawful conduct.

29. In relation to the imposition of shortfall penalties, Alesco NZ's Counsel advanced the argument that based on the anti-avoidance case law at the time that Alesco NZ entered into the OCNs, Alesco NZ's tax position was about as likely as not to be correct and implied that the Court might have reached a different conclusion at that time. The Court of Appeal, however, stated that they would have reached the same conclusions on the OCNs in 2003. The Court also noted that:

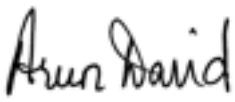
    (a) The fact that Alesco NZ received positive expert tax advice does not mean that it was correct;

    (b) Alesco NZ also knew that the accounting treatment of the transaction did not dictate its tax treatment; and

    (c) The issue by the Commissioner of *Determination G22A* is open to construction as a direct message to those taxpayers like Alesco NZ which adopted the HINZ template that there was no room for argument on the issue.

30. In response to the submission that Alesco NZ did not take an abusive tax position, the Court of Appeal noted that it is required to view the arrangement objectively by reference to its features rather than Alesco NZ's intentions. The focus is on the purpose of the arrangement itself. The Court of Appeal was satisfied that Alesco NZ entered into the transactions for the dominant purpose of avoiding tax and took an abusive tax position within the meaning of s. 141D of the *Tax Administration Act 1994*. The Court stated:

    "[149] … The more Alesco NZ's case is examined, the more it reinforces our conclusion."



Arun David, Director

DavidCo Limited