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WEEKLY COMMENT: FRIDAY 24 JULY 2015

1. This week I continue looking at issues relating to tax deductibility and review Taxation Review Authority ("TRA") *Case* 10/2015, TRA 013/10 [2015] NZTRA 10, 29 June 2015, which concerned whether management fees paid by a trust to an associated company was deductible or whether it was a tax avoidance arrangement.

2. This case highlights the consequences of a regretted choice: the use of an impermissible means of reducing a tax liability cannot be justified by pointing to an alternative permissible means that could have been used instead to achieve the same tax result.

Case 10/2015: Deductibility of management fees paid by a trust to an associated company

3. *Case* 10/2015 concerned a deduction claimed for management fees of $1,116,000 paid by the taxpayer, the corporate trustee of a land-holding trust, to a wholly-owned company ("Land Ltd"), a tax loss company, which was due to be sold. The sole director of the corporate trustee was a discretionary beneficiary of the trust, and was also director of Land Ltd. The trust, together with related trusts and companies had combined direct and indirect interests worth close to $100m.

4. The Commissioner disallowed the deduction on the basis that it did not have the required nexus with the taxpayer's income or business carried on to derive income. If it did have the required nexus, the Commissioner alleged it was a tax avoidance arrangement. The Commissioner had imposed a 100% shortfall penalty for abusive avoidance, or, at least, a 20% penalty for an unacceptable interpretation, in both cases reduced by 50% for previous good behavior.

5. In the income year in question, 2005, the trust earned rental income, interest and dividends amounting to $1.77m. It undertook management services for its related companies and trusts and also undertook funding obligations and responsibilities. However, it had no employees and evidence was given that it used the management services provided by Land Ltd, for which it paid Land Ltd $1,116,000.

6. Land Ltd had a substantial business in its own right. It owned an office block worth $20m, which was debt funded to the amount of $15m. The annual rent was in excess of $2m. It paid management fees to management companies owned by its director and another associated individual, of nearly $500k in 2005 as well as a shareholder's salary of $125k (and in the previous year, 2004, management fees of just over $400k and a similar shareholder's salary). Land Ltd also engaged another company related to its shareholder/director for administration and office services and also incurred administration and legal costs of its own.

7. Land Ltd was due to be sold and was sold towards the end of the 2006 income year. Apparently, its sale had been contemplated for some time and an agreement was negotiated in April/May 2005 and entered into in July 2005. The trust's tax return for the 2005 income year, claiming the management fees as a deduction, was prepared and filed after this happened, in March 2006. Land Ltd had a tax loss of close to $1m, which would have ceased to be available once the change in shareholding took place. The payment of the management fees allowed the tax loss to be used before the company was sold.

8. There were some pertinent aspects relating to the management fees that the judge set out in the decision:

   (a) There was no written management agreement between the trust and Land Ltd.

   (b) There were also no formal agreements between Land Ltd and the management companies to which it, in turn, paid management fees.

   (c) There was no documentary evidence of any services having been provided by Land Ltd to the trust. Emails and other documents showing work done on property development and property management activities had apparently been made available to the Commissioner, but were not produced in evidence.

   (d) The management fees for 2005 were recorded in the accounts of both the trust and Land Ltd by way of journal entry adjusting loan accounts used to allocate liability for loan facilities provided by HSBC. The 12 journal entries were dated the last day of each month, but they were consecutively numbered and they were all made at the same time.

   (e) There were no management fees paid by the trust to Land Ltd in the previous year, 2004, or in the subsequent year, 2006, up to the time of Land Ltd's sale. Evidence was given that there should have been management fees paid by the trust to Land Ltd in 2004, and that some of the 2005 fees related to 2004, but there was no specific breakdown of the management services between the two years.

   (f) The management fees of $1,116,000 paid by the trust to Land Ltd in 2005 amounted to 63% of the trust's total income for the 2005 year. It was exactly equal to the taxable trustee income of $1,116,000 the trust would otherwise have had after distributing dividends received as beneficiary income.

   (g) After Land Ltd was sold, the tax losses of Land Ltd would have been unavailable for use by the trust and its related entities. The trust was the only entity in its "group" in a profit position able to absorb Land Ltd's tax loss.

   (h) Evidence was given that the reason why management fees were paid instead of the trust simply distributing its income to Land Ltd was that charging a management fee was considered to more correctly reflect the commercial reality, which was that Land Ltd was providing valuable management services to the trust.

Deductibility of the management fees

9. The judge noted that the general permission and the body of case law built around it established that:

   (a) A deduction is only available for expenditure that has the necessary relationship with the taxpayer and with the gaining or producing of his assessable income (*Commissioner of Inland Revenue v Banks* [1978] 2 NZLR 472 (CA));

(b) The heart of the inquiry is the identification of the relationship between the advantage gained or sought to be gained by the expenditure and the income earning process (*Buckley and Young Ltd v Commissioner of Inland Revenue* [1978] NZCA 22, [1978] 2 NZLR 485 (CA));

(c) The provision that allows a deduction for expenditure necessarily incurred in the course of carrying on a business for the purpose of deriving assessable income facilitates deductibility where the conduct of a business may require expenditures to be made which cannot be directly linked to the derivation of assessable income but which are made to, say, keep the enterprise on foot or to reduce expenditure (*Cox v Commissioner of Inland Revenue* (1992) 14 NZTC (HC) 9,164).

10. In the circumstances, the judge noted that:

(a) Simply recording management fees as an entry in the trust's financial statements does not establish that management services were provided: *Caffe Italiano Majoribanks Ltd v Caffe Italiano Wellington Ltd* (HC Wellington CIV 2011- 485-877) cited;

(b) There was no evidence given of any documentary evidence of any services having been provided by Land Limited to the Trust;

(c) There was no evidence of any company resolution or agreement between the trust and Land Ltd for the charging of management services;

(d) There was no invoice for the management fees or supporting accounts for any of the work allegedly done;

(e) Much of the work described related to associated trust and other separate entities, rather than the income earning processes of the trust and expenses incurred by those separate entities are not deductible by the trust: *Odham's Press Limited v Cook* [1940] UKHL TC_23_233, [1940] 3 All ER 15;

(f) While it was not in issue that the trust required management, there was no evidence that any management services were supplied by Land Ltd – in fact, the trust paid management fees of $36k separately to the management company of the director of its corporate trustee.

11. The taxpayer relied on the decision in *Lockwood Buildings Ltd v Commissioner of Inland Revenue* (1996) 17 NZTC 12,483 (HC) to support its contention that a "rough and ready" allocation of expenses is usual and acceptable. *Lockwood Buildings* concerned the deductibility of $119,280 of total management fees amounting to $1,901,821 paid by a subsidiary to its parent company. The parent company had paid $119,280 to consultants to investigate the feasibility of investing in the forestry industry. The Commissioner contended that $119,280 of the management fees paid by the taxpayer was not deductible because it was expenditure on capital account.

12. In *Lockwood Buildings*, the High Court found that the expenditure on management fees by the subsidiary was not on capital account and was deductible because it was part of larger management fees that related to management services provided on a continuing basis, well beyond the investigation into the forestry investment.

13. From the point of view of the taxpayer's submissions in the present case, the important aspect of *Lockwood Buildings* was the evidence of the managing director of the parent company and the evidence given by a partner in the firm that provided accounting services to the group, that:

    "… there was no direct relationship between the total cost incurred by (the parent company) ... in providing management services and the aggregate management fees which it charged … Nor was there any specific item of cost incurred … which was passed on ... Lockwood Buildings was charged and paid a global amount for the entire range of services ... provided …

    ... the (parent company) determined the overall level of management fee income which it considered appropriate ... This amount was then divided between the operating companies on the basis of a number of criteria, the most significant was the 'ability to pay'.... (which) was merely a proxy for the company's ability to pay, the size of its operations and, accordingly, the general level of management services which it was regarded as using."

14. However, the TRA in the present case noted that in *Lockwood Buildings*:

    (a) The management fees were paid on an annual basis and were paid every year;

    (b) The services for which the management fees were paid were also provided on a continuing basis;

    (c) The manager satisfactorily performed its function for the subsidiary in negotiating contracts, ensuring it had access to a supply of wood, etc.; and

    (d) The parent company had incurred properly documented costs in providing the management services and did not recover the full amount of its costs.

15. The High Court stated in *Lockwood Buildings* that:

    "… looking at the matter overall, in order to enhance its profitability, Lockwood Buildings dispensed with its in-house management and arranged for those management services to be provided by a service company. It paid a fee for those services. It was immaterial to Lockwood Buildings how that fee was made up provided that it obtained the services it required. … In business conglomerates it is commonplace for members of the same group to trade with one another. … The payer is generally unconcerned and unaware how the fee is comprised and whether it includes components of goods, services, administration, overhead and profit."

16. While *Lockwood Buildings* tends to support the charging of undissected lump sums as management fees within a group of companies, the question of whether the necessary nexus had been established between the expenditure and the taxpayer's income was not at issue in that case. In the present case, the judge was "not satisfied on the evidence that (management) services were provided" and therefore there was no nexus between the expenditure of $1,116,000 incurred on management fees and the gaining or producing of the trust's income.

Tax avoidance

17. The existence of an arrangement was not in dispute. The fees charged equalled the trustee income that would otherwise have been derived, and payment of the management fees meant the trust had no tax to pay.

18. In deciding that the arrangement was outside the purpose and contemplation of Parliament and constituted tax avoidance, the judge noted that:

    (a) While Parliament had clearly contemplated the sharing of profits and losses in a group company situation, it could not be said this extended to permitting offsetting between a company and a trust.

    (b) It made no commercial sense to fix a fee solely by reference to the trust's taxable income, particularly at the level charged.

    (c) Management fees were charged by Land Ltd to the trust only in 2005. In 2004, management services were provided directly by the management companies of the shareholder/director of the corporate trustee and his associate and fees set at a realistic level were paid for those services.

    (d) The whole transaction was contrived and artificial and served no commercial purpose, therefore, the tax avoidance purpose or effect of the arrangement was not merely incidental.

Reconstruction and the question of a hypothetical alternative

19. The disallowance of the deduction resulted in taxable trustee income equal to the management fees. The taxpayer objected on the grounds that:

    (a) If management fees had not been charged, the income would have been distributed as beneficiary income to Land Limited and the shareholder/director of the corporate trustee, both of whom had tax losses available to eliminate any taxable income; and

    (b) Voiding the transaction should remove the tax effect of the transaction entirely, which would mean reducing the assessment of income to Land Ltd and that had not happened.

20. The judge noted that it was established by the Court of Appeal in *Alesco New Zealand Limited v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175 that:

    "[39] … The question is whether the particular arrangement had the effect of avoiding or reducing any liability to income tax. It is not whether (the taxpayer) would have been equally able to avoid or reduce its liability by implementing an alternative and permissible arrangement. …

    [40] … the wording of the anti-avoidance provisions, when construed according to their text and purpose, does not allow a taxpayer to rewrite history by postulating an alternative arrangement once the one it has adopted is impugned."

21. The Commissioner had contended that distributing the amount paid as management fees as beneficiary income would not have entirely eliminated the tax liability because of the rule requiring imputation credits to be apportioned over the distributions to beneficiaries. Therefore, some of the imputation credits attached to dividends would have had to be distributed to Land Ltd, which had tax losses and could not make use of them. The judge dismissed this argument as hypothetical as well.

22. The judge concluded that the Commissioner is not obliged to adopt a hypothetical approach to reconstruction, and the disallowance of the deduction claimed by the trust was the only step the Commissioner needed to take to counteract the tax advantage.

Shortfall penalty for abusive tax position

23. The judge noted that there is a judicial precedent that the inappropriate use of management fees could form part of a tax avoidance arrangement:

    (a) In *Case T59* (1998) 18 NZTC 8,429, Judge Barber had held that the contention that profits of a subsidiary could be transferred to a parent company "by way of an administration charge for which no services have been rendered is without authority and is contrary to public policy and statutory law".

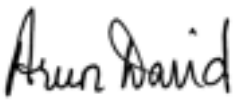
    (b) Subsequently, in *O'Neil & Ors v. Commissioner of Inland Revenue (New Zealand)* [2001] UKPC 17 the Privy Council held that "… the administration charge was partly a conduit for the money which was to be returned to the shareholders and partly a fee payable … for the use of the scheme".

24. The judge decided that the transaction had a dominant purpose of avoiding tax because:

    (a) The taxpayer failed to prove that management services were provided to the trust by Land Ltd; and

    (b) The only purpose of claiming the deduction for the management fees was to transfer the trust's taxable income to Land Ltd.

25. Therefore, the judge found that a shortfall penalty of 100% for taking an abusive tax position could be imposed under s. 141D of the *Tax Administration Act 1994*, reduced by 50% for previous good behavior under s. 141FB. The tax shortfall was $368,280, therefore, the shortfall penalty imposed was $184,140.



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