IN THE COURT OF APPEAL OF NEW ZEALAND

I TE KŌTI PĪRA O AOTEAROA

CA740/2018
[2020] NZCA 383

BETWEEN	COMMISSIONER OF INLAND REVENUE Appellant
AND	FRUCOR SUNTORY NEW ZEALAND LIMITED Respondent

Hearing:	11–12 February 2020
Court:	Kós P, Gilbert and Courtney JJ
Counsel:	J B M Smith QC, E J Norris and L K Worthing for Appellant L McKay, M McKay and H C Roberts for Respondent
Judgment:	3 September 2020 at 9.30 am

JUDGMENT OF THE COURT

A The appeal is allowed.

B The orders made in the High Court are set aside. The interest assessments are reinstated. Shortfall penalties do not apply.

C The appellant is entitled to costs for a complex appeal on a band B basis and usual disbursements. We certify for second counsel.

D Costs in the High Court are to be determined by that Court in accordance with this judgment.

REASONS OF THE COURT

(Given by Gilbert J)

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Introduction

[1] The Commissioner of Inland Revenue (the Commissioner) seeks to disallow deductions claimed by Frucor Suntory New Zealand Ltd (Frucor)[1] in respect of a tax-driven structured finance transaction entered into by Frucor in March 2003 (the funding arrangement). In terms of the funding arrangement, Deutsche Bank advanced $204 million[2] to Frucor in exchange for a fee of $1.8 million and a convertible note (the note) redeemable at maturity in five years' time at Deutsche Bank's election by the issue of 1,025 non-voting shares in Frucor. The bulk of Deutsche Bank's advance of $204 million was funded by a contemporaneous payment of $149 million by Frucor's then Singapore-based parent, Danone Asia Pty

[1] Frucor was originally incorporated under the name Danone Holdings New Zealand Ltd on 17 January 2002. It changed its name to Frucor Holdings New Zealand Ltd on 30 January 2009, and subsequently amalgamated with Frucor Beverages Ltd on 19 May 2009 under the latter's name. It eventually changed its name to Frucor Suntory New Zealand Ltd on 30 June 2017.

[2] Except where stated in this judgment, amounts have been rounded for ease of expression.

Ltd (DAP), for the purchase of the shares from Deutsche Bank in five years' time at a pre-agreed price matching the face value of the note (the forward purchase agreement). The balance of $55 million was contributed by Deutsche Bank. Upon receipt of the $204 million from Deutsche Bank, Frucor immediately returned $60 million of capital to DAP in a share buyback and the balance of $144 million was paid in satisfaction of an existing loan from another Danone entity, Danone Finance SA in France.

[2] The coupon on the note was payable semi-annually in arrears at 6.5 per cent per annum. A total of $66 million was paid by Frucor to Deutsche Bank over the five-year term calculated on an interest only basis on $204 million. Frucor claimed interest deductions in respect of these coupon payments which equated to the amount required to pay amortising principal and interest on the $55 million introduced by Deutsche Bank.[3] At maturity, Deutsche Bank exercised its option to accept repayment by the issue of the shares and these were then transferred immediately to DAP in accordance with the forward purchase agreement. The funding arrangement can be portrayed diagrammatically as shown in the appendix.

[3] The Commissioner contends that the funding arrangement was a tax avoidance arrangement in terms of s BG 1 of the (now repealed) Income Tax Act 2004 (the Act) and therefore void against her. The deductions in issue in this proceeding are $10,827,606 and $11,665,323 for the 2006 and 2007 income years respectively.[4]

[4] The Commissioner claims that as a matter of commercial and economic reality the $66 million coupon payments represented principal and interest payments required to fully repay an amortising loan from Deutsche Bank of $55 million. She says the balance of $149 million received from Deutsche Bank (to make up the $204 million advanced under the note) was effectively paid to Frucor by its 100 per cent parent DAP for the issue of 1,025 shares in Frucor at the expiry of the arrangement in year five at a pre-agreed price of $204 million. According to the

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3 The $55 million principal was provided by Deutsche Bank's internal Treasury.

4 The Commissioner accepts that she cannot disallow deductions claimed for prior years in respect of this arrangement because of the four-year time bar in s 108 of the Tax Administration Act 1994. The dispute between the Commissioner and Frucor in relation to the 2008 and 2009 income years remains in abeyance pending resolution of the present dispute.

Commissioner, Deutsche Bank was merely the conduit for the payment and issue of these shares which came at no cost to Frucor. DAP owned all the shares in Frucor throughout.

[5] In summary, the Commissioner says Frucor is entitled to a deduction for the interest paid on $55 million, which she accepts was advanced by Deutsche Bank. The deduction for interest payable on this amount, $11 million over the five-year term of the funding arrangement, is not challenged. The dispute is confined to the balance of the claimed interest expense, being $55 million paid on the balance of $149 million. Frucor contends this is a legitimate interest cost because the full $204 million was advanced and interest was paid on it totalling $66 million over the five-year term.

[6] Frucor succeeded in the High Court.[5] Muir J found that the funding arrangement was not a tax avoidance arrangement.[6] The Judge accordingly declared that the Commissioner's assessments for the 2006 and 2007 income years were incorrect and he made orders cancelling those assessments.[7] The Judge considered that Frucor did not take an unacceptable tax position and so he would have set aside the shortfall penalties imposed of $1,786,555 and $1,924,779 even if he had been wrong on his principal conclusion.[8]

The issues

[7] The issues on appeal are:

(a) Did the High Court err in finding that the funding arrangement was not a tax avoidance arrangement under s BG 1 of the Act?

(b) Did the Commissioner correctly counteract the tax advantage under s GB 1 of the Act? Frucor argues there was no tax advantage even if this was a tax avoidance arrangement. Muir J did not need to deal with

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5 *Frucor Suntory New Zealand Ltd v Commissioner of Inland Revenue* [2018] NZHC 2860 [High Court judgment].
6 At [204].
7 At [223].
8 At [221]–[222].

this issue because of his principal finding.[9] Frucor has given notice supporting the High Court judgment on this additional ground.

(c) Did the High Court err in finding that shortfall penalties should not be imposed in any event?

[8] Before addressing these issues, we will briefly summarise the key terms of the transaction documents comprising the funding arrangement and the context in which they were entered. We will say more about the background when we come to address the tax avoidance issues in detail. We also summarise the steps taken when the transaction closed on 18 March 2003 and at maturity five years later.

The funding arrangement

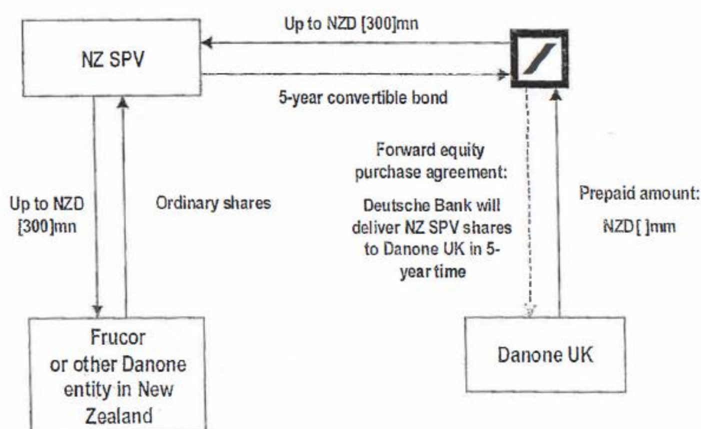
Context

[9] In January 2002, Deutsche Bank provided a confidential financing proposal to Groupe Danone SA (Groupe Danone or Danone), the ultimate parent company based in France, in connection with the proposed acquisition of Frucor Beverages Group Ltd and its subsidiaries in New Zealand. The proposal was styled "Efficient Financing Alternatives for Danone in New Zealand". Two structures were proposed, a convertible note structure and an alternative structure based on the sale and lease back of registered trademarks.

[10] The convertible note structure, which was the genesis of the eventual funding arrangement, anticipated that Deutsche Bank would pay the New Zealand Danone special purpose vehicle (SPV) up to $300 million to subscribe for a five-year convertible note. This would be backed by a contemporaneous forward purchase agreement with "Danone UK" under which Deutsche Bank would deliver the SPV shares to Danone UK on conversion at the end of the arrangement in five years' time in return for an unspecified pre-paid amount as follows:

[9] At [212].

Convertible Note Structure: Summary Description



Alternatively, NZ SPV could lend to Danone NZ/Frucor. Interest on the loan would then be available to meet interest on convertible notes. This could be preferable from a NZ perspective as DB NZ needs to establish that the shares it delivers to Danone UK are worth the FV amount (ie NZ$300m) which is easier if the SPV only has a loan to Danone NZ.

Deutsche Bank

[11] Deutsche Bank summarised the tax treatment as being that the coupons paid by the New Zealand SPV on the convertible note would be fully deductible, the funding costs of Danone UK should also be fully deductible, and there should be no capital gains tax on the acquisition of the SPV shares purchased by the Danone UK subsidiary (provided the shares were not sold). Deutsche Bank noted that the 75 per cent thin capitalisation rules applicable in New Zealand would need to be taken account of "in order to determine the size of the transaction".

[12] Frucor was formed on 17 January 2002 as the acquisition vehicle. As it transpired, the convertible note funding arrangement was not formalised until over a year later, in March 2003. In the meantime, the purchase price of approximately $297 million for the acquisition of Frucor Beverages Group Ltd was funded as to $150 million by DAP subscribing for 1,000 ordinary shares in Frucor at $150,000 per share. The balance of $147 million was funded by an inter-company loan from Danone Finance, a subsidiary of Groupe Danone also based in France.

[13] In July 2002, Groupe Danone entered into a mandate agreement appointing Deutsche Bank as the exclusive and sole arranger of the proposed convertible note.

Its services were to include structuring the issue of the convertible note and assisting Groupe Danone and the issuer to prepare appropriate documentation for the transaction. A structuring fee of EUR 100,000 was to be paid to Deutsche Bank but this would be credited against arrangement fees (subsequently agreed at USD 1 million) charged by Deutsche Bank on the closing of the transaction.

[14] On 14 March 2003, Frucor, DAP, Groupe Danone, Compagnie Gervais Danone (another France-based Danone company) and Deutsche Bank entered into a series of transactions, together comprising the funding arrangement, as follows.

Convertible note deed

[15] A convertible note deed between Frucor and Deutsche Bank with a face value of $204,421,565 and coupon interest of 6.5 per cent per annum payable bi-annually — a total of $66.51 million payable over the five-year period. At maturity in five years, the principal amount of $204,421,565 was to be repaid unless Deutsche Bank exercised its option to take 1,025 non-voting shares in Frucor in satisfaction of the loan. It is common ground that Deutsche Bank would elect to have repayment of the principal amount satisfied by the issue of the shares in all but a doomsday scenario. However, if, for whatever reason including incapacity, impossibility or illegality, Frucor failed to issue the shares on the redemption date, Frucor was obliged to pay the redemption amount in cash.[10]

Forward purchase deed

[16] A forward purchase deed between Deutsche Bank (as seller), DAP (as buyer) and Compagnie Gervais Danone (as novation counterparty) for the purchase by DAP of the 1,025 non-voting shares in Frucor to be issued to Deutsche Bank pursuant to the convertible note deed. The forward purchase deed was conditional upon the issue of the convertible note and the execution of the side letter referred to below. In terms of the forward purchase deed, DAP was required to make an upfront payment of $149 million to Deutsche Bank on the issue date of the convertible note (18 March

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[10] Under the convertible note deed, the redemption amount was equal to the aggregate of the principal amount and all accrued, unpaid interest owing at the redemption date.

2003) in return for the transfer of the shares in five years' time (upon receipt by Deutsche Bank on maturity of the note).

[17] Again, it is common ground that this is how the forward purchase agreement would be completed in all but a doomsday scenario. However, two other possibilities were provided for. First, in the event the shares were not issued by Frucor as required under the convertible note deed despite notice of share election having been given by Deutsche Bank, then Deutsche Bank would satisfy its obligations under the forward purchase deed by paying the novation amount to Compagnie Gervais Danone as the novation counterparty. This obligation was conditional on Deutsche Bank having received the redemption amount. Secondly, in the extremely unlikely event Deutsche Bank did not give notice to Frucor requiring its obligations to be satisfied by issuing the shares on the maturity date, then, subject to Deutsche Bank receiving the redemption amount, it was required to pay that amount to DAP grossed up to cover DAP's liability to pay tax in Singapore on the difference between the redemption amount ($204,421,565) and the purchase price ($149 million). The evidence was that this tax liability would be approximately $14 million.

Side letter

[18] A side letter in terms of which Deutsche Bank, DAP and Compagnie Gervais Danone agreed for the purposes of s EH 48(3)(a) of the Income Tax Act 1994 (then applicable) that $204,421,565 was the lowest price the parties would have agreed on the date of the forward purchase agreement if payment was required in full at the time the shares were transferred.

Convertible note guarantee

[19] A guarantee between Groupe Danone and Deutsche Bank whereby Groupe Danone guaranteed Frucor's payment obligations to Deutsche Bank under the convertible note deed up to a maximum of $250 million. Deutsche Bank paid a guarantee fee of 0.1 per cent per annum on the $204 million principal amount, with payment of this fee being made bi-annually on the same dates as interest was payable on the convertible note.

Forward purchase guarantee

[20] A guarantee between Groupe Danone and Deutsche Bank in terms of which Groupe Danone guaranteed DAP's payment obligations to Deutsche Bank under the forward purchase agreement up to a maximum of $67 million. DAP's sole payment obligation under the forward purchase agreement was the upfront payment of $149 million. The figure of $67 million covered Deutsche Bank's exposure to the note, being the amount of $55 million (plus interest) it contributed over and above the purchase price of $149 million paid by DAP. There was no fee payable to Groupe Danone in connection with this guarantee.

Steps at inception — 18 March 2003

[21] On the issue date, 18 March 2003, DAP paid $149 million under the forward purchase agreement to Deutsche Bank. This payment was funded by a loan of $89 million from a third party lender, BNP Paribas (based in Singapore). The balance of $60 million was funded by a payment from Frucor to DAP to re-purchase 400 of its shares at the issue price of $150,000 per share.

[22] Deutsche Bank borrowed $55,534,000 from Deutsche Bank Treasury in Singapore. Of this, $55,421,565 was added to the $149 million received from DAP to make up the advance of $204,421,565 paid to Frucor under the note.

[23] As noted, Frucor applied $60 million of the borrowing to pay DAP for the re-purchase and cancellation of 400 of its shares. The balance of $144 million was used to repay the loan from Danone Finance mentioned at [1]. Frucor also paid Deutsche Bank's fee of USD 1 million (NZD 1,816,860) for organising the funding arrangement.

Steps at maturity — 18 March 2008

[24] On 20 February 2008, Deutsche Bank duly gave notice to Frucor in accordance with the convertible note deed requiring it to satisfy its obligations to repay the principal amount outstanding by issuing shares on the maturity date. At maturity on 18 March 2008, Frucor issued 1,025 new non-voting shares to Deutsche Bank

which immediately transferred those shares to DAP pursuant to the forward purchase agreement.

Subsequent return of capital

[25] We note for completeness that later in the year, on 22 December 2008, Frucor re-purchased from DAP 747 non-voting shares and 307 ordinary shares thereby returning $204,421,565 of surplus capital to DAP. This followed DAP's sale in October 2008 of 100 per cent of the shares in Frucor to Suntory (NZ) Ltd, a subsidiary of a Japanese beverage manufacturer and distributor.

Legal principles

[26] Section BG 1 of the Act provides that a tax avoidance arrangement is void as against the Commissioner for income tax purposes. Tax avoidance is defined by s OB 1 of the Act to include directly or indirectly altering the incidence of any income tax. Income tax means New Zealand income tax imposed under the Act.[11] A tax avoidance arrangement is an arrangement that directly or indirectly has tax avoidance as its purpose or effect, or has tax avoidance as one of its purposes or effects if the purpose or effect is not merely incidental. An arrangement means an agreement, contract, plan or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect.

[27] The leading authority on tax avoidance in New Zealand is the Supreme Court's decision in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*.[12] The majority (Tipping, McGrath and Gault JJ) considered that the specific tax provisions and the general anti-avoidance provision should be construed so as to give appropriate effect to each.[13] An arrangement includes all steps and transactions by which it is carried out. Even if all the steps are unobjectionable in themselves, tax avoidance may be found in their combination.[14] A two-step approach is required. First, it must be determined whether the use made of the specific provision is within

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11 Income Tax Act 2004, s OB 6.
12 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289.
13 At [103].
14 At [105].

its intended scope. If so, the second question is whether the taxpayer has used the specific provision to alter the incidence of income tax in a way that cannot have been within the contemplation of Parliament when enacting the provision.[15] Relevant factors in this assessment may include the manner in which the arrangement is carried out, the role of all relevant parties and their relationship with the taxpayer, the economic and commercial effect of the transactions, the duration of the arrangement and the nature and extent of the financial consequences for the taxpayer. A classic indicator of the use of a specific provision outside Parliament's contemplation is where an arrangement is structured to enable the taxpayer to gain the benefit of a specific provision in an artificial or contrived way.[16]

[28] The court must look beyond purely legal considerations and have regard to the use of the specific provision in the light of the commercial reality and economic effect of that use. The majority summarised the ultimate enquiry in these terms:[17]

> The ultimate question is 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.

High Court judgment

[29] There was no contest on the first step of the *Ben Nevis* enquiry. It is common ground that in terms of the specific provisions Frucor was entitled to claim a deduction for the $66 million paid to Deutsche Bank as interest on the $204 million advance.[18]

[30] Turning to the second question, the Judge assessed the arrangement in the light of the factors identified in *Ben Nevis* under four headings: the manner in which the arrangement was carried out; the role of all relevant parties and their relationship to the taxpayer; the economic and commercial effect of the documents; and whether there was artificiality and contrivance.

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15 At [107].
16 At [108].
17 At [109].
18 High Court judgment, above n 5, at [89].

[31] The Judge commenced by noting that the transaction involved real money flows. DAP borrowed $89 million from BNP Paribas. DAP paid $149 million to Deutsche Bank. Deutsche Bank paid $204 million to Frucor. Frucor paid $144 million to Danone Finance and $60 million to DAP for the share buyback. Frucor made bi-annual payments of interest at the agreed rate of 6.5 per cent per annum on the face value of the note over the five-year term. There was no dispute that all of this involved "real money".[19]

The manner in which the arrangement was carried out

[32] The Judge observed that there was a degree of circularity because of the contemporaneous re-purchase of share capital from DAP and DAP's forward purchase of share capital.[20]

[33] The Judge accepted that the manner in which the face value of the note was fixed was "unusual". The "very particular sum" ($204,421,565) was a "strong indicator" that the company's medium term financing requirements did not drive the face value of the note.[21] The Judge found that the amount of the note was fixed by adding to the sum of $149 million payable under the forward purchase agreement the present value of five years' worth of coupons calculated by reference to the five-year New Zealand dollar swap rate.[22] The price did not reflect any share price volatility as would normally be the case where funding is provided using a convertible note instrument.[23]

[34] However, the Judge considered that because this was an off-market transaction in the context of "a related party refinancing or debt-equity adjustment", this was not "a significant indicator of avoidance".[24] Although "the pricing may have been unorthodox in an open market context", the rate was not "artificially increased to maximise deductions". The factors driving the price in this off-market transaction did

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19 At [141(a)].
20 At [141(b)].
21 At [141(c)].
22 At [141(d)].
23 At [141(e)].
24 At [141(f)].

not "predicate avoidance". To find otherwise "would be to place convertible notes within a straightjacket of orthodoxy".[25]

[35] The Judge considered it was useful to benchmark the arrangement against alternative structures identified by Frucor in its submissions. These included: Frucor borrowing an additional $60 million from Danone Finance to achieve its desired debt/equity ratio; DAP or Danone Finance lending $204 million to Frucor for five years at 6.5 per cent by interest bearing debt or convertible note; and Frucor issuing a convertible note to Deutsche Bank on the same terms but with Deutsche Bank funding the $149 million forward purchase amount by way of a loan from DAP, Danone Finance or some other third party.[26] There could be no question of tax avoidance under any of these alternative arrangements.[27] The Judge accepted that the distinguishing feature of these alternative arrangements was that they would give rise to assessable interest in the hands of the relevant offshore Danone entity whereas the present funding arrangement negated foreign assessable income. The Judge observed that the avoidance of foreign tax is not tax avoidance for the purposes of s BG 1.[28]

[36] The Judge accepted Frucor's submission that full deductibility for interest paid by it was "an entirely normative New Zealand taxation outcome of related party or third-party debt funding" and that this outcome was not attributable to any feature of the arrangement that might be described as unorthodox, artificial or contrived.[29]

The role of all relevant parties and their relationship to Frucor

[37] The Judge observed that all the parties were related apart from Deutsche Bank and BNP Paribas.[30] However, this was unremarkable in the context of a refinancing and equity reduction.[31] The Judge accepted that it is unlikely the funding arrangement would have been entered into without DAP's participation and its relationship to Frucor. Deutsche Bank was not in the business of acquiring equity holdings in groups

25 At [141(g)].
26 At [141(j)].
27 At [141(k)].
28 At [141(l)].
29 At [141(m)].
30 At [142].
31 At [143].

such as Danone, the shares were non-voting, and there was no history of Frucor declaring dividends. The forward purchase agreement ensured that the ownership of Frucor would remain unchanged. DAP intended that Deutsche Bank would simply be a conduit of the shares.[32]

[38] Deutsche Bank's role was seen to be pivotal. It was the architect of the scheme and it received a fee of $1.8 million for its role. The Judge accepted that Deutsche Bank's lending was not intended to generate any return and the only benefit to Deutsche Bank beyond the fee was the anticipated enhancement of its relationship with Groupe Danone.[33]

The economic and commercial effect of the documents

[39] The Judge summarised the Commissioner's position that the commercial and economic reality was that Deutsche Bank provided funding of $55 million on which Frucor paid $11 million in interest.[34] The balance of $149 million was paid to Frucor by DAP with Deutsche Bank merely acting as a conduit in what was a "costless exercise".[35] The Judge said it was "correct that on a Danone Group basis this is exactly as the transaction was understood, including for accounting purposes". It was also correct that Deutsche Bank "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".[36]

[40] However, the Judge expressed reservations about the Commissioner's approach on this aspect of the analysis. Mr Smith QC, for the Commissioner, was particularly critical of this part of the Judge's reasoning, so we set out the relevant passage in full:

> [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

32 At [144].
33 At [145]–[147].
34 At [150(a)].
35 At [150(b)].
36 At [155].

> from [Deutsche Bank] 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.

[41] The Judge continued:

> [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 [Frucor]) at the net external position of entities under common control; and
>
> (b) [Frucor] does not incur a cost requiring tax recognition when it issues shares to satisfy its debt liability.

Artificiality and contrivance

[42] The Judge turned to consider whether Frucor gained the benefit of the specific provision in an artificial and contrived way, cautioning that this was "not simply whether, compared to arm's length norms, aspects of the transaction might be described as unorthodox or even artificial".[37]

[43] The Judge accepted there was an element of circularity as identified by the Commissioner but he considered this did not materially advance her case because the payment by DAP to Deutsche Bank ($149 million) discharged a genuine contractual liability and Frucor's payment of part of Deutsche Bank's investment to DAP ($60 million) had both a legitimate commercial purpose and resulted in a "real change to Frucor's funding structure". The Judge did not see the circularity as being in the "offensive" category.[38]

[44] The Judge accepted that the note was "unorthodox" given its "unusually precise face value" and that it "was priced as if it was a non-convertible instrument".

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37 At [158].
38 At [163].

However, the Judge did not see this as evidence of artificiality and contrivance.[39] The Judge also accepted that the commercial relationship between Groupe Danone and Deutsche Bank "assumed a share 'pass through' and DAP's ongoing 100 per cent ownership of its subsidiary" but said that "does not establish artificiality".[40] The Judge considered that whether the convertible note was effectively mandatory rather than optional was "irrelevant to the core issue of deductibility" and "takes the matter little further".[41]

[45] The Commissioner argued that there could be no non-tax reasons for using a convertible note backed by a forward purchase agreement in circumstances where Deutsche Bank could not participate in any equity uplift and DAP already owned all the shares in Frucor. The Judge answered this submission by saying that it ignored or understated tax reasons "which featured in the calculus but are, in fact, legitimate aims that are not indicative of New Zealand tax avoidance".[42] Here, the Judge was referring to the non-taxable gain to DAP in Singapore for the difference between the $149 million paid under the forward purchase agreement and the pre-agreed value of the shares in five years' time ($204,421,565).

[46] The Judge rejected the Commissioner's submission that the shares issued by Frucor to Deutsche Bank in satisfaction of the note came at no cost to Frucor.[43] He considered that "a focus on 'cost' is capable of misdirecting the required analysis".[44] The Judge ultimately saw the issue as being a simple one:[45]

> 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.

[47] The Judge was satisfied the shares not only constituted good consideration, they had real value. Even with the restriction on voting rights, the shares would have achieved a price if offered on the open market. There was therefore an opportunity

39 At [164].
40 At [170]–[171].
41 At [172].
42 At [166].
43 At [173]–[193].
44 At [177].
45 At [190].

cost to Frucor in issuing the shares to Deutsche Bank. There was also some commercial risk, however well-managed, in issuing shares to an unrelated third party.[46]

Overall assessment

[48] Having addressed these various factors, the Judge turned to his overall assessment of whether this was a tax avoidance arrangement.[47] He commenced by stating that he found the test difficult to apply, noting that the exercise "can be an elusive quest".[48] The starting point was that Parliament can be assumed 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 if a member of a multi-national group and issue shares to satisfy a liability to a third party, including its parent.[49] Parliament contemplated the use of optional convertible notes and that coupons on them calculated at an arm's length rate would ordinarily be deductible. The Judge considered Parliament was "agnostic" about the use of convertible note structures between parent and subsidiary.[50] He considered it relevant that other debt structures could have been used to deliver the same tax benefits to Frucor without prospect of challenge under s BG 1.[51]

[49] The Judge re-stated that Frucor received $204 million in cash from Deutsche Bank. He said this could not be "gainsaid". He emphasised that this was "real money" and it was "expended". The interest was incurred and paid.[52]

[50] The Judge considered that "the grouped 'economic' approach" said to have been adopted by the Commissioner was inconsistent with New Zealand's international tax regime and also selective because it ignores that $89 million of the forward purchase payment was funded outside the Danone group by

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46 At [193].
47 At [194]–[204].
48 At [194].
49 At [195].
50 At [197].
51 At [198].
52 At [199].

BNP Paribas.[53] Further, applying the Commissioner's analysis, the funding arrangement involved principal payment deductibility even if satisfaction of the note and forward purchase agreement occurred by way of cash settlement or novation.[54] The Judge considered that the funding arrangement had "legitimate economic drivers, primary among them offshore tax minimisation".[55] The Judge concluded that the Commissioner had not appropriately invoked s BG 1:[56]

> Interest was incurred by [Frucor] 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.

Submissions on appeal

[51] As noted, Mr Smith acknowledges that the legal form of the arrangement satisfies the relevant deduction provisions — s DB 7 of the Act (allowing a deduction for interest incurred) and the financial arrangements rules in subpt EW of the Act (together the specific provisions). However, he submits that in economic terms, Frucor effectively received $149 million from its 100 per cent parent in return for 1,025 shares which it issued to its parent five years later. He contends the issue of those shares came at no cost to Frucor and Deutsche Bank was merely a conduit for both transactions. Mr Smith argues that Frucor has claimed deductions as if it had made interest payments of $66 million whereas, in reality, this was the amount of principal and interest required to discharge the loan of $55 million by Deutsche Bank.

[52] Mr Smith claims the Judge did not carry out the second stage of the *Ben Nevis* enquiry, instead adopting a "threshold" approach, in which there is no room for s BG 1 if the specific provisions are met. This approach was doubted by this Court and firmly rejected on appeal in the Supreme Court.[57] Mr Smith argues that the Judge placed improper emphasis on the legal form of the transactions and their "black letter" law

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53 At [196].
54 At [200].
55 At [203].
56 At [203].
57 *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21,323 at [116]– [118] and *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 12, at [104] n 113.

compliance. In doing so, he contends that the Judge failed to examine the economic substance of the arrangement, wrongly concluding that to do so would involve taxation by economic equivalence.[58] Further, he says the Judge's statement that "a focus on 'cost' is capable of misdirecting the required analysis" was incorrect.[59] Mr Smith submits that, on the contrary, the enquiry under s BG 1 requires consideration of the commercial and economic reality of the $204 million funding amount. He says Parliament cannot have intended that a forward purchase of equity by a 100 per cent parent at a pre-agreed higher future value should entitle the issuer to a tax deduction for interest expenditure in the amount represented by the pre-agreed value increase. Mr Smith also submits the Judge was wrong to find that the unorthodox and unusual features of the transaction were not significant or indicative of tax avoidance. Finally, he contends that the Judge misapplied the "merely incidental" test in the definition of "tax avoidance arrangement" in s OB 1 of the Act.

[53] Mr L McKay, for Frucor, submits that Muir J was not only correct to find that s BG 1 had no application to the arrangement, but that all steps in his reasoning were also correct. This reflects the Judge's acceptance of Frucor's arguments in their entirety.

[54] Mr McKay says the "significant error" in the Commissioner's position is to treat the Danone group exposure to Deutsche Bank as the basis for carrying out the second stage of the *Ben Nevis* enquiry. He says that is fundamentally contrary to Parliament's intention that the tax position of a New Zealand subsidiary of an international group must be determined as a single economic entity, not on a consolidated group basis. The Commissioner's "net loan" or "group" approach is inconsistent with Parliament's intention that transactions between New Zealand resident taxpayers and offshore group members should be taxed on an independent, arm's length basis. An interest payment is not to be disregarded because it is made to an offshore group member and would be ignored by both entities under financial reporting consolidation. So, for example, the initial loan from Danone Finance of around $150 million, which attracted an arm's length margin of interest above

58 High Court judgment, above n 5, at [149]–[154]. Mr Smith refers particularly to [153] which we have quoted at [40].
59 At [177].

the floating rate, would be disregarded on consolidation but would be fully recognised in determining Frucor's deductible interest expenditure and taxable income.

[55] Mr McKay submits that the Commissioner's "economically costless" proposition is based on the same flawed analysis advanced by her experts in support of the "group" approach. He points out that the issuance of equity is disregarded applying this approach even under the cash and novation redemption alternatives provided for in the forward purchase agreement. Mr McKay submits that the Commissioner's "no cost" argument is wrong in any event. Parliament plainly contemplated that a debt discharged through the issuance of shares would not prevent full interest deductibility for the debt. It is well established that shares issued for a consideration other than cash must be treated as at least equal in value to the par value of those shares. There is no distinction in this context between shares issued to a parent or to a third party. He says there is no reference in any relevant determinations suggesting that debt remission income arises to a debtor/issuer on the basis of the absence of economic cost in the share issue.[60] Further, he argues that the "costless" proposition conflates as a one-step transaction what could equally be two, namely a payment for shares and the use of the proceeds to repay the debt. Mr McKay submits that Parliament must be taken to have contemplated that the discharge of a debt liability through share issuance would have no impact on the issuer's entitlement to interest deductions otherwise available on the debt.

[56] Mr McKay argues that even if the proper analysis is to view Frucor as receiving $149 million from DAP in return for the issue of shares in five years, this would be a financial arrangement entitling Frucor to a $55 million deduction for the difference between the $149 million (assumed) receipt and the $204 million tax value of the shares at the end of the five-year period.

[57] In summary, Mr McKay submits that the economic and commercial reality of Frucor's position was that it borrowed $204 million. It used this money to repay borrowing from Danone Finance (as to $144 million) and to fund the share buyback (as to $60 million). In terms of International Financial Reporting Standards (IFRS),

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[60] See at [108]–[114] and [183]–[193] for a discussion on Determination G22/G22A (optional convertible notes) and Determination G5C (mandatory convertible notes).

and in particular IFRS 10, Frucor was required to recognise a liability of $204 million and an interest cost of $66 million. All Deutsche Bank and Danone documents confirmed these liabilities of Frucor. Even on a group basis, the Danone group liability to unrelated parties was higher than $55 million ($89 million having been borrowed from BNP Paribas).

Tax avoidance

[58] There is no doubt that, as a matter of legal form, Frucor was able to make use of the relevant specific provisions to claim a full deduction for the interest expenditure on the sum of $204,421,565. As the Judge found, this sum was advanced to Frucor and expended by it. There is also no question that Frucor paid approximately $66 million in interest calculated on this sum at the agreed rate over the five-year term.

[59] Nevertheless, for the reasons set out below, we have reached the conclusion that Frucor used the specific provisions to claim deductions for interest in an artificial and contrived manner that cannot have been within Parliament's contemplation. We consider that when the economic and commercial effect of the funding arrangement is examined in its context, it becomes clear that tax avoidance was its principal purpose or effect or, at least, tax avoidance was not merely an incidental purpose or effect of the arrangement. In summary, we accept the Commissioner's submission that by entering into the funding arrangement Frucor achieved a $66 million interest deduction without incurring a corresponding economic cost for which Parliament intended deductions would be available. As a matter of commercial and economic reality, $55 million of the claimed interest represented the repayment of principal borrowed from Deutsche Bank and was not an interest cost. We have therefore concluded that the Commissioner was entitled to invoke s BG 1.

Evidence in the High Court

[60] There is no dispute about the relevant background. The funding arrangement was based on a generic tax driven convertible note funding structure developed by Deutsche Bank at some stage prior to 2002 for promotion to its clients. By 2002, Deutsche Bank had executed the structure in various different jurisdictions, including New Zealand, and claimed to have received "positive rulings" from tax advisors.

Danone Groupe was familiar with the structure, having considered using it in conjunction with Deutsche Bank for an earlier proposed transaction in Argentina.

[61] In late 2001, Deutsche Bank discussed with Danone the possibility of using the convertible note structure as a means of financing the then proposed acquisition of Frucor Beverages Ltd in New Zealand. In January 2002, Deutsche Bank presented two "Efficient Financing Alternatives for Danone in New Zealand". We referred to this at [9] above. This presentation was prepared prior to the purchase. It records that Danone was currently looking at various financing alternatives "in connection with its [$294 million] take-over offer". The figure of $294 million compares with the price agreed on 14 January 2002 of $297,522,000. The proposal also assumes that there will be no minority shareholders, recording that "Danone has obtained 90% of Frucor and is therefore in a position to claim the remaining 10%". However, in the event minority shareholders remain whose approval would be required to issue the note, a workaround is suggested.

[62] The so-called efficient financing alternatives presented by Deutsche Bank were the convertible note structure and an alternative structure styled "Trademark Financing". It is clear that the perceived 'efficiency' lay in the tax benefits.

[63] The convertible note structure was addressed under four headings — Structure, Tax Treatment, Advantages and Constraints. Although the transaction was described as a "5-year convertible bond", the underlying premise was that repayment of the advance would inevitably be satisfied by the issue of shares. So, for example, it stated that the note "*will* convert into a fixed number of shares" and "Deutsche Bank *will* deliver NZ SPV shares to Danone UK in 5-year[s'] time" (emphasis added). At that stage it was expected (based on discussions in late 2001) that Danone UK would provide the funding. However, Deutsche Bank stated that other Danone entities in "countries such as Germany or Luxembourg could be considered".

[64] After the brief outline of the structure, Deutsche Bank addressed the tax treatment by stating: the coupons payable by the New Zealand entity on the convertible note would be fully deductible, there should be no capital gains tax on the acquisition of the shares purchased by the Danone subsidiary; and the funding

costs of Danone UK should also be fully deductible. We note in passing that on 12 March 2003, shortly prior to the transaction closing, Deutsche Bank calculated that the "pre-tax equivalent benefit from the transaction" was approximately $24 million.

[65] The advantages of the proposal were said to be that the structure was familiar to Danone and there would be no VAT or GST issues. The single constraint mentioned was that a "75% thin capitalisation rule applies in New Zealand and should be taken into account in order to determine the size of the transaction". Assuming a $300 million acquisition, the note could not exceed $225 million.

[66] Danone advised Deutsche Bank in early February 2002 that it wished to go ahead with the convertible note structure and suggested the fee that should be paid to Deutsche Bank for its role. This was confirmed in an internal Deutsche Bank email on 4 February 2002 which set out the next steps stipulated by Danone:

> Actually Yes!
>
> They've now confirmed they want to go ahead with the convertible structure. Next steps they've asked for are (i) New Zealand memorandum/opinion confirming deductibility of coupons; (ii) UK memorandum/opinion relating to forward purchase; and (iii) termsheet.
>
> The UK side of this I had prepared before when we looked at the Argentinian deal. Can you get something from an [sic] NZ lawyer for them? On the termsheet I'll start a draft and send it over to you.
>
> Concerning fees they have suggested upfront arrangement fee of $1mio plus credit spread and costs (the idea would be that the credit spread is set by Corporate Bank in Paris who provide risk weighted assets and take the credit risk in return for earning the credit spread. Accordingly SCM [Deutsche Bank Structured Capital Markets] just keeps the upfront fee but has no credit risk etc). Danone's justification for this level of fee is:
>
> 1. Fees for these transactions in Europe are generally 1% of the principal. Here the principal on the notes is only about $80mio;
>
> 2. We had agreed to execute the Argentinian transaction for this pricing (although this is because it would have been a ground-breaking transaction for Emerging Markets in Argentina. Also we expected to earn more by selling the notes to a tax sparing investor);
>
> 3. They have (apparently) been inundated by other banks willing to execute this structure with them in New Zealand (they have a moral commitment to us arising out of Argentina).

> Accordingly we should probably accept this but let me know what you think (there is also a lot of glory in this with DCM who have been trying to develop the relationship with Danone).
>
> …

[67] Three points may be noted about this email. The first is that full deductibility of the coupons payable by the New Zealand entity (Frucor) was critical; confirmation of this was the first required step. Secondly, the "principal" that Deutsche Bank would lend on the convertible note was estimated to be about $80 million. This compares with the eventual figure of $55 million. This is consistent with the Commissioner's contention that, as a matter of economic reality, the principal was $55 million and the $66 million claimed as an interest expense represented the repayment of this principal plus interest on it. Thirdly, this email shows that this was an unusual lending transaction, purposely structured to achieve tax benefits. For example, the lender does not normally have zero credit risk and stand to profit from the transaction only by receipt of an upfront fee. Nor is it usual for the borrower to suggest the fee. The focus is on the shares, with no serious consideration given to the prospect of the loan being repaid in cash.

[68] By 24 May 2002, the expected face value of the note was $225 million and the forward purchase payment $154 million. The $225 million equated to 75 per cent of $300 million, thus complying with the thin capitalisation rules. The calculation of the $154 million was explained in a document distributed on that date headed "Project Falcon", the project name ascribed to the transaction by Deutsche Bank. The purchase price payable by DAP "on day one will be calculated as the face value of the convertible note less the present value of the convertible note coupon payments discounted at the applicable zero coupon swap rate plus credit margin (0.35%)". By way of illustration, if the face value of the note was $225 million, then the purchase price payable under the forward purchase agreement would be $154 million, being $225 million less $71 million (the present value of semi-annual coupons of $8.7 million at the then applicable interest rate of 7.736 per cent per annum). Deutsche Bank would fund the "net investment" (approximately $71 million) from its normal market sources for New Zealand dollars "swapped to an amortising flow that matches the profile of the net investment". There is a brief explanation of what will happen on termination in five years — "the convertible note will be cancelled and

a fixed number of ordinary shares will be issued by [Frucor] to [Deutsche Bank] under the conversion terms of the note. [Deutsche Bank] will deliver a completed transfer in respect of those shares to [DAP].” The purpose of the arrangement was set out under a heading “Summary” — “[the] structure provides term funding to [Frucor] at an after tax cost that is significantly below the Group’s normal cost of funds (ie. pre-tax equivalent of approximately minus 1.50%)”.

[69] This document was used as a template and updated from time to time as the transaction progressed towards completion. By 18 September 2002, the figures had changed somewhat, including because of interest rate fluctuations. The face value of the note was now expected to be $215 million and the forward purchase price $151 million, being $215 million less $64 million (the present value of semi-annual coupons of $7.69 million or 7.15 per cent per annum). By this time, there was some additional protection for Danone in that the shares to be issued by Frucor would be non-voting (the word “ordinary” before “shares” has been struck through on this revision).

[70] The net funding figure of $64 million had dropped to $61 million by 29 November 2002. An internal Deutsche Bank email sent on that date explained the net effect of the transaction — “Danone raises approx NZD61m for [five] years on amortising basis”. Again, this is consistent with the Commissioner’s contention that Frucor claimed interest deductions for what were, as a matter of commercial reality, repayments of principal and interest over five years.

[71] An internal Deutsche Bank approval document prepared based on data as at 2 December 2002 provides further confirmation of the purpose of the five-year structured transaction — it “is designed to provide cheaper, tax efficient funding to [Frucor]”. The difference between the face value of the note (then $225 million) and the forward purchase payment ($154 million), being $71 million, “will be amortised from the convertible coupons (nominal payments estimated at NZD 87mn)”. It can be seen that the payments to be made by Frucor represented repayment of principal and interest over the five-year term on an amortising basis. This was how the tax efficiency was to be achieved — Frucor would claim interest deductions for what were described as “nominal payments” of interest of $87 million on the face value of the note

($225 million) but, in effect, paying principal and interest on the net funding amount of $71 million.

[72] A closing agenda was prepared in the lead up to signing. This anticipated that execution versions of the documents would be circulated on 3 March 2003. Rate setting would occur on 6 March 2003 at 8 pm New Zealand time. This would determine the final amounts to be written in to the documents. Execution of the transaction documents and formal issue of the required professional opinions (in the relevant jurisdictions) would follow in sequence half an hour later:

> 6 March 2003 Rate Setting:
>
> 8.00am (Paris time)/ 8.00pm (NZ time)/ 3.00pm (Singapore time):
>
> 1. [Deutsche Bank] calculate forward purchase price and convertible coupon rate
>
> 2. [Groupe Danone] agrees forward purchase price and coupon rate
>
> 3. Russell McVeagh inserts forward purchase price and coupon rate into final documents and faxes relevant pages to [Groupe Danone]
>
> Execution of documents:
>
> 8.30 am (Paris time)
>
> …

[73] By 3 March 2003, the forward purchase amount was fixed at $149 million. Instead of this figure being derived from the face value of the note using the applicable discount rate, the reverse position was adopted. The face value of the note became a function of the forward purchase amount. At that stage it was anticipated that the rate would be set at 9 pm New Zealand time with the designated person at Deutsche Bank advising his counterpart at Danone of the five-year swap rate and the consequent "net funding amount", both to be confirmed by Danone:

> **Rate set Thurs 6 Mar at 9.00 am Paris time/ 9.00 pm NZ time/7.00 pm Sydney:**
>
> 1. [Deutsche Bank representative] advise [Danone representative] 5 yr swap rate

2. [Deutsche Bank] calculate net funding amount and advise [Danone representative].

3. Convertible Principal Amount is total of NZD149m (ie Forward Purchase Price) + net funding amount.

4. [Danone representative] to confirm that he is happy with 1,2 &3 above.

[74] One of the few available Danone documents is an internal memorandum sent on 11 March 2003 by Pierre-André Terisse, the Danone representative referred to in the email quoted above and the person responsible for agreeing to the "net funding amount" and the final amount of the note. Mr Terisse explained that his memorandum was "intended to give a brief description of the transaction for signatories". His memorandum included the following summary:

> **The structure**, established by Deutsche Bank, works as follows:
>
> - issuance by [Frucor] of **215 m NZD convertible bonds**, subscribed by Deutsche Bank
> - Deutsche Bank keeps the principal amount, which gets reimbursed over 5 years
> - But sells the conversion rights to [DAP] for an amount of 149 m NZD
> - At the end of the 5 years, **shares issued** in repayment of the bonds are **transferred to [DAP]**, or, as a fallback, to Compagnie Gervais Danone.
>
> **Benefits obtained**
>
> - <u>Financing cost</u>: extremely attractive for NZD financing.
> - <u>NZD financing</u>: putting a debt in the same currency as cash-flows of the company acquired provides us with a natural hedging; furthermore, interest [is] located in the same country as operating income.
>
> **Issues**
>
> - Legal / tax issues have been checked by France Hasselman, tax opinions have been obtained

[75] The rate setting and final calculation of the face value of the note did not occur until 14 March 2003. An internal Deutsche Bank email sent that day following execution of the documents confirms:

> … For your info, the rates/amounts agreed with Danone today are as follows:
>
> | | |
> |---|---|
> | Convertible Note Principal | NZD204,421,565 |
> | Interest rate | 6.50% pa payable 18 Sept/18 Mar |

Issue Date	18 Mar 2003
Maturity Date	18 Mar 2008
Forward Purchase Price	NZD149,000,000

Therefore net funding amount is NZD55,421,565

…

[76] A Project Falcon summary document prepared by Deutsche Bank post-execution confirmed how the note issue price and the net funding amount were derived and how the net funding amount was to be serviced:

> …
>
> The net funding requirement is therefore the difference between the convertible note issue price and the share forward purchase price. This funding will be serviced by the convertible note interest payments. …
>
> …
>
> The funding for the net amount (i.e. note subscription less prepaid forward purchase price) was provided by [Deutsche Bank Treasury] to [Deutsche Bank Structured Capital Markets] by way of a 5 yr NZD amortising loan, to be fully serviced by the note interest payments. …
>
> …

[77] This understanding was shared by Danone. In a document prepared on 15 October 2003 concerning the Frucor funding arrangement, under a heading "Purpose and 'débouclage' of the operation", it is stated:

> During the 5 years, [Frucor] pays coupons to Deutsche Bank. Those coupons are analyzed differently according to tax/statutory and consolidated accounts:
>
> - For statutory, coupons considered as interest expenses deductible for tax purposes. They amount to a total of some [$66 million] … The necessary cash is provided by dividends received from Frucor.
>
> - For consolidation, coupons paid are analyzed in two separate elements 1. Reimbursement of Deutsche Bank loan for [$54 million] and 2. interest expense on this loan for the difference, i.e. [$12 million]. As this is a permanent difference, no deferred tax shall be recorded in consolidated accounts.
>
> At maturity date:
>
> - [Frucor] reimburses the remaining [$150 million] loan from Deutsche Bank by delivering its 40% own shares previously bought back from [DAP]

- Deutsche Bank delivers those shares to [DAP], without receiving any cash, as [$150 million] were paid in advance in 2003
- [DAP] holds 100% of [Frucor] shares, as it was prior to the [funding arrangement].

[78] We refer to one more Danone document confirming the nature and purpose of the arrangement. This document, which is not dated, includes the following section:

> **What was the point of the scheme?**
>
> The scheme allowed [Frucor] to finance the purchase of Frucor in a way that would entitle it to tax credits for the life of the scheme.
>
> Under the arrangement [Frucor] made two coupon payments to [Deutsche Bank] each year. The coupon payments were approximately $7m per payment and were funded by payment of a fully imputed dividend … to [Frucor]. These coupon payments were treated differently for Management and Statutory purposes.
>
> For **Stat (and Tax)** purposes, the whole payment was treated as an interest expense. The interest payment was 100% deductible. Total payments over the life of the scheme added up to $66m, which equated to $21.8m of tax credits (approx $4.4m for each year of the scheme's life).
>
> For **Management** purposes, part of the payment was treated as an interest expense, and part was treated as repayment of the principal of the convertible note loan.
>
> …

[79] Professor Moorad Choudhry was one of the expert witnesses called by the Commissioner.[61] Professor Choudhry has specialist expertise in debt capital markets, bond and fixed income instruments and convertible bonds. His assessment of the Frucor convertible note (which we accept) was as follows:

> 75. The [Frucor] bond is a [convertible bond] or note in name only. It was issued not to enable a growing company to offer shares to outside investors who were prepared to lend it money at a lower rate because they wanted to benefit from the rise in value of said shares: the seller was already wholly owned by a company that entered into a legal agreement to own these shares ultimately. The lender had no interest in acquiring shares in [Frucor], which were not offered in any case, and simply structured a transaction that generated

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[61] Professor Choudhry, who lives in Surrey, England, is a Fellow of the Chartered Institute for Securities and Investment and the London Institute of Banking and Finance. He has a PhD in financial economics from the University of London and is an Honorary Professor at University of Kent Business School. He is currently a partner in Moorad Choudhry Financial Ltd. In his professional career spanning over 30 years, he has held senior positions at major investment banks and other financial institutions. Professor Choudhry has published numerous books and articles, including on debt capital markets, bond and fixed income instruments and convertible bonds.

> tax benefits for [Frucor] in return for a fee. [Deutsche Bank NZ] exposed itself to no credit risk to [Frucor], and its exposure to Danone Group during the life of the convertible note was transferred to [Deutsche Bank Paris].
>
> 76. It may well be that [Frucor] entered into the transaction, and applied for tax relief on the convertible note debt interest, in good faith and in the understanding that tax treatment of its debt interest would be as expected. That said, there is no doubt that this is not a conventional [convertible bond] but rather a "pretend" construct of a [convertible bond], which has the effect of generating a tax benefit.
>
> 77. Critically, without the advice and solutions presented by the investment bank in the first instance, it is highly unlikely that the treasury department of a corporate entity would propose the use of a convertible bond issued by a subsidiary it already owned, in this way. In any other context[,] other than the New Zealand tax relief one[,] this transaction would be described by a neutral observer as having no purpose.

[80] Stanley Marcello Jr., the Senior Director of Tax for Danone North America, was the only witness to give evidence for Frucor. He was the Senior Regional Tax Manager of DAP from 1 April 2015 to 27 November 2016. His first role with the Danone group of companies commenced in February 2006, three years after the funding arrangement was implemented. Mr Marcello provided a summary of the transaction documents and their context. Although he had no personal involvement in the funding arrangement, Mr Marcello suggested several reasons why it may have been entered into (apart from the New Zealand tax benefit). These were cash accumulation/retention benefits, future expanded capital base, Singaporean tax treatment, lower fixed interest rate funding for Frucor, local currency funding and improved debt/equity ratio for Frucor.

[81] However, we accept Mr Smith's submission based on Professor Choudhry's evidence that these outcomes were readily achievable simply by borrowing the same amount from a bank in New Zealand over the same term at the same interest rate. At the end of the five-year period, Frucor could then have issued shares to DAP in exchange for the principal amount required to repay the bank. No tax would be payable by DAP in Singapore in respect of the receipt of these shares. No fee of $1.8 million would need to be paid to a third party. Mr Marcello's evidence therefore does not assist in explaining why this convertible note structure would have been adopted, if it was not for a tax-driven purpose.

Assessment

[82] It seems to us to be reasonably plain that the funding arrangement had New Zealand tax avoidance as one of its purposes or effects and this was not merely incidental to some other purpose. The primary purpose of the funding arrangement was the provision of tax efficient funding to Frucor. That was its stated goal. The tax advantage was gained in New Zealand through the interest deductions Frucor claimed. DAP (in effect) paid $149 million to Frucor for the shares on day one but with the payment being structured to enable Frucor to claim interest deductions on it over a five-year term. This tax beneficial outcome was achieved by calculating the amount that needed to be added to the $149 million to enable interest payments on that grossed-up sum over five years to match the amount required to repay over the same period the amount of the gross-up plus interest (the funds introduced by Deutsche Bank). Frucor was thereby able to repay the $55 million advanced by Deutsche Bank plus interest over the five-year term of $11 million but claim the entire $66 million as an interest deduction.

[83] DAP's subscription for equity was effectively repackaged as a loan from Deutsche Bank to achieve the intended tax benefits for Frucor. DAP's equity subscription was bundled with an amortising loan from Deutsche Bank in an artificial and contrived manner to enable Frucor to claim interest deductions on the loan which were, in substance, repayments of principal and interest payable to Deutsche Bank in respect of the funds it introduced to facilitate the arrangement.

[84] The Judge was persuaded that the purpose of the funding arrangement was to negate foreign assessable income, such as the taxable receipts of interest paid to Danone Finance under the initial funding arrangement.[62] We agree that avoiding offshore tax was an important consideration. The funding arrangement gave rise to the prospect of generating an unwelcome offshore taxable gain because of the notional increase in the value of the non-voting shares over the five-year period from $149 million to $204,421,565 (or whatever other figure happened to be generated by the formula at the date of closing). This potential problem needed to be managed for the funding arrangement to succeed. However, we view the need to avoid capital gains

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[62] High Court judgment, above n 5, at [141(1)].

tax on the notional share value growth as a condition precedent to the intended funding arrangement rather than being its object. The condition was always understood to be readily satisfied simply by choosing a Danone entity resident for tax purposes in a jurisdiction that would not impose capital gains tax on the inferred uplift in the value of the shares represented by the difference between the forward purchase amount and the face value of the convertible note. Thus, this condition had to be ticked off before the funding arrangement could proceed but that was never going to be a problem. This consideration does not detract from our assessment that a more than incidental purpose and effect of the funding arrangement was to engineer tax deductions for interest expenses claimable by Frucor in New Zealand of sufficient magnitude to repay Deutche Bank. That purpose was not to come at the expense of creating tax problems elsewhere.

[85] We consider the funding arrangement fits within the Supreme Court's formulation in *Ben Nevis* as one enabling the taxpayer to gain the benefit of the specific provision in an artificial and contrived way. In our view, this transaction was in many respects artificial and it was clearly contrived for the very purpose of enabling Frucor to gain the benefit of the specific provision allowing interest deductions. The artificial and contrived features of the funding arrangement are not seriously in dispute and most were accepted by the Judge. Taken together, they reveal that the purpose of the arrangement was to dress up a subscription for equity as an interest only loan to achieve a tax advantage. It is hard to discern any rational commercial explanation for the artificial and contrived features of the arrangement, other than tax avoidance.

[86] Deutsche Bank made no profit from its participation as the notional lender of $204 million and it plainly had no interest in acquiring 1,025 non-voting shares in Frucor, a company that had never declared a dividend. The benefits to Deutsche Bank were its fee of $1.8 million for the design and implementation of the arrangement and to enhance its relationship with Groupe Danone. Those benefits aside, Deutsche Bank's interest was in recovering the money it contributed to facilitate the arrangement together with interest. This would be accomplished by the interest payments to be made by Frucor over the five-year period, all of which were secured by the guarantee from Groupe Danone (mentioned at [19] above). As to the remaining balance of $149 million funded by DAP, this would be satisfied by Deutsche Bank

exercising its option to call for the shares from Frucor and passing them immediately to DAP under the forward purchase agreement.

[87] In the extremely unlikely event Deutsche Bank chose not to call for the shares and Frucor redeemed the loan by paying $204 million in cash, Deutsche Bank was required to gross-up this redemption payment upon receipt in order to make DAP whole for its consequent tax liability. This would have required Deutsche Bank to make an additional payment of some $14 million from its own resources. Plainly, Deutsche Bank would ensure that did not happen. In the equally unlikely event of Frucor paying Deutsche Bank $204 million rather than issuing 1,025 non-voting shares (despite Deutsche Bank calling for the shares), Deutsche Bank would not be entitled to enjoy that receipt and face down any claim by DAP that it had suffered a loss as a result of not receiving these further (non-voting) shares in a company it already wholly owned. Instead, Deutsche Bank would be required to pay the $204 million to the novation counterparty, Compagnie Gervais Danone. While technically an optional convertible note, it was to all intents and purposes mandatory.

[88] The convertible note issue price of $204,421,565 was itself a contrived figure. Despite what was stated in the side letter, the figure had nothing to do with the likely value of 1,025 non-voting shares in Frucor in five years' time. Deutsche Bank had no interest in acquiring these shares and DAP already owned all the shares in Frucor. Additional, non-voting, shares would have no value to it. Nor did the note issue price match Frucor's funding requirement of approximately $147 million to repay the loan from Danone Finance. We know that because Frucor contemporaneously paid $60 million of the $204 million advance straight back to DAP.

[89] Rather, as we have seen, the very precise figure of $204,421,565 was derived from other inputs, being the sum to be contributed by DAP for the purchase of the shares, the term of the arrangement, the agreed interest rate and bi-annual payment dates. The figure was mathematically derived by grossing up the amount Frucor required ($147 million to repay Danone Finance and $2 million for Deutsche Bank's fee) such that interest on the grossed-up total paid bi-annually at the agreed rate over five years would be sufficient to repay the amount of the gross-up plus interest on that

amount if paid bi-annually at the same rate over the same period. This can be expressed more simply using the following formula:

P1 ($149 million) + P2 = P3

Where interest on P3 = P2 + interest on P2

Thus, P2 (and consequently P3) are wholly derived from P1($149 million contributed by DAP) and the interest calculation.

Therefore:

$149 million + $55 million = $204 million

Where interest on $204 million = $55 million + interest on $55 million ($11 million)

[90] As a matter of commercial and economic reality, the payment of $149 million made by DAP did not carry any liability for Frucor (or Deutsche Bank) to pay interest. The only amount that did attract interest was the $55,421,565 independently advanced by Deutsche Bank.

[91] It is not relevant that Frucor could have borrowed the $204 million from Danone Finance at an arm's length rate of interest and be entitled to claim the same interest deductions. The focus must be on the arrangement that was entered into, not one that might have been entered into but was not. We therefore agree with the Judge's first proposition in [153] of his judgment (quoted at [40] above). However, this prohibition does not preclude consideration of the economic and commercial effect of the transaction under scrutiny. Such consideration, focusing entirely on the funding arrangement in question, is central to the second stage of the *Ben Nevis* analysis. It is by no means "almost meaningless" or a "mere checkpoint for the Commissioner to divert around" as the Judge suggested.

[92] Mr McKay emphasised that it is necessary to examine Frucor's position on a standalone basis rather than considering the position of the Danone group on consolidation. We agree with this, although, as he acknowledges, it is necessary to consider all the transaction documents comprising the funding arrangement and the steps taken to implement them when assessing the tax avoidance issue. To that extent, the involvement of other relevant members of the Danone group must be considered.

[93] Mr McKay contends that the Commissioner has wrongly taken a group approach in suggesting that the loan was in effect only $55 million, not $204 million. Mr McKay points out that the references in the accounts to the $55 million as being a net loan reflect the group position on consolidation. By contrast, Frucor's annual accounts consistently show a liability of $204 million and an interest expense of $66 million.

[94] This argument found favour with the Judge.[63] However, it seems to us that the financial statements merely reflect the correct legal and accounting position. They confirm the correctness of the conceded position in terms of step one of the *Ben Nevis* enquiry, but they cannot be dispositive at step two. Otherwise, there would be no room for a tax avoidance argument based on the commercial and economic reality of the payment. So long as it could be shown that expenses were treated correctly from an accounting perspective and in accordance with the legal form of the underlying transactions, that would be the end of the matter. Mr McKay acknowledged that the financial statements cannot be conclusive, but he commended them as a good starting point.

[95] In any case we are not persuaded that the Commissioner focused on the group position at the expense of considering Frucor's individual position as the New Zealand taxpayer whose income was being assessed. The Commissioner's assessment of the transaction from a tax avoidance perspective did not depend on the consolidated accounts for the group. Rather, her focus was on the economic and commercial reality of the payments claimed by Frucor as an interest expense, contending these represented payments of principal and interest to Deutsche Bank. That is precisely how they were calculated — the interest payments on the grossed-up loan had to equal principal and interest on the Deutsche Bank advance. This assessment is not dependent on the group consolidated accounting position, although the consolidated position may coincide with the effective commercial and economic position of an individual group member.

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63 At [78] and [196].

[96] It is well-established that a debt can be discharged by the issue of shares. Further, where shares are issued for a consideration other than cash, this must be treated as being at least equal to the par value of the shares.[64] We therefore readily accept Mr McKay's submission that Parliament must have contemplated that a debt discharged by the issuance of shares would not prevent full interest deductibility on the debt. We would not get past step one of the *Ben Nevis* analysis if we did not agree with that uncontroversial proposition. However, Mr McKay's submission assumes there is otherwise full interest deductibility on the debt. That in turn assumes the payments are properly viewed as interest payments, not just as a matter of "black letter" legal and accounting form, but also as a matter of commercial and economic reality. That comes back to the central issue in the case. We respectfully disagree with the Judge to the extent he suggested it would suffice at step two of the enquiry to accept that shares may be issued to discharge a debt and any further consideration of underlying "cost" would be misdirected.[65]

[97] Mr McKay's fall-back position is that even if it can be said that Frucor effectively received $149 million from DAP in return for the issue of shares in five years' time, this would be a financial arrangement entitling Frucor to a $55 million deduction based on the difference between the amount paid and the agreed value of the shares at the end of the period. The difficulty with this proposition is that the figure of $204,421,565 was an artificially contrived figure and had nothing to do with the value of the shares. The capital requirement was $147 million (plus the fee). That was the amount DAP subscribed for the additional non-voting shares. These additional shares conferred no additional rights on DAP and their "value" to DAP would not grow over the five-year period. In reality, these shares had no value to DAP (as the 100 per cent parent) so long as they did not end up with a third party. The funding arrangement was designed to ensure that would not happen.

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64 *Osborne v Steel Barrel Co Ltd* [1942] 1 All ER 634 (CA) at 637–638, *Craddock v Zevo Finance Co Ltd* [1944] 1 All ER 566 (CA) at 569, and *Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd* [1983] 1 AC 501 (HL) at 517.

65 High Court judgment, above n 5, at [177] and [190] (quoted in part at [46] above).

Tax advantage

[98] Section GB 1 of the Act provides that where an arrangement is void in accordance with s BG 1, the taxpayer's deductions and assessable income may be adjusted by the Commissioner as she thinks appropriate "to counteract any tax advantage obtained" by the taxpayer "from or under" the arrangement.

[99] The Commissioner counteracted the tax advantage by reducing the deductible interest expense claimed by Frucor in 2006 and 2007 from approximately $13 million per annum (6.5 per cent on $204 million) to around $2.3 million per annum (6.5 per cent on the amortised balance of $55 million).

[100] Mr McKay submits that because the Commissioner must only reconstruct to the extent required "to counteract any tax advantage", it is necessary to identify the base level of permissible deductions that would have existed in any event. For this proposition he relies on the following passage from the judgment of McGechan J in *BNZ Investments Ltd v Commissioner of Inland Revenue*:[66]

> … I have no doubt s [GB 1] is intended to counteract tax advantages obtained out of avoidance, but not otherwise. Where tax advantages are increased through avoidance which would have existed in any event, it is that increment above base level which is to be counteracted, not the legitimate base level itself. That is all the preservation of the tax base — the purpose of the section — requires.

[101] Mr McKay points out that the funding arrangement refinanced the initial acquisition funding provided by Danone Finance of $144 million at a comparable rate of interest. If the present arrangement had not been entered into, there is some evidence to indicate that the level of debt to equity would have been increased to around the same level as achieved by the funding arrangement. Viewed in that way, the funding arrangement yielded no tax advantage and therefore, even if it was a tax avoidance arrangement void against the Commissioner, there is no basis to deny the full amount of the interest deductions claimed. Alternatively, Mr McKay submits that the appropriate comparison is with the initial funding arrangement with Danone Finance in terms of which incontestable deductions of interest on the debt of approximately $144 million were available.

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66 *BNZ Investments Ltd v Commissioner of Inland Revenue* (2000) 19 NZTC 15,732 (HC) at [200].

[102] Mr McKay also points out that the Commissioner's approach ignores DAP's external liability to BNP Paribas in respect of the $89 million component of the funding. He says this liability was undoubtedly incurred as an element of the overall funding arrangement with the result that interest legitimately incurred on this sum should be treated as being deductible on any reconstruction. On this basis, of the $204 million funding provided to Frucor, just over 70 per cent came from sources external to the group ($55 million from Deutsche Bank plus $89 million from BNP Paribas). Mr McKay therefore submits that a similarly proportionate part of the interest expense — at least $46.5 million — should be deductible on a reconstructed basis.

[103] Section GB 1 does not require the Commissioner to consider other arrangements the taxpayer might have entered into had it not chosen to proceed with the tax avoidance arrangement under review.[67] Further, the tax advantage with which the section is concerned is the New Zealand tax advantage achieved by the New Zealand taxpayer — Frucor. While DAP is a party to the funding arrangement, its funding costs and tax position are irrelevant to the analysis that must be conducted under s GB 1.

[104] We have already concluded that the principal driver of the funding arrangement was the availability of tax relief to Frucor in New Zealand through deductions it would claim on the coupon payments. The benefit it obtained under the arrangement was the ability to claim payments totalling $66 million as a fully deductible expense when, as a matter of commercial and economic reality, only $11 million of this sum comprised interest and the balance of $55 million represented the repayment of principal. The tax advantage gained under the arrangement was therefore not the whole of the interest deductions, only those that were effectively principal repayments. We consider the Commissioner was entitled to reconstruct by allowing the base level deductions totalling $11 million but disallowing the balance. The tax benefit Frucor obtained "from or under" the arrangement comprised the deductions claimed for interest on the balance of $149 million which, as a matter of commercial reality, represented the repayment of principal of $55 million.

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[67] *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175 at [122]–[128].

Shortfall penalties

[105] Section 141B of the Tax Administration Act 1994 provides that a taxpayer takes "an unacceptable tax position" if, viewed objectively, the tax position fails to meet the standard of being "about as likely as not to be correct". The Commissioner contends that is the position here. In terms of s 141D, taxpayers who have taken an unacceptable tax position are liable to pay shortfall penalties if they enter into or act in respect of arrangements with a dominant purpose of taking or supporting the taking of tax positions that reduce or remove tax liabilities or give tax benefits. The Commissioner accordingly contends that shortfall penalties are applicable here. In short, Frucor has taken an unacceptable tax position viewed objectively and tax avoidance was the dominant purpose of the arrangement. The Commissioner acknowledges that Frucor is entitled to a 50 per cent reduction for previous behaviour in terms of s 141 FB of the Tax Administration Act.

[106] Mr M McKay, who dealt with this aspect of the argument for Frucor, submits that the "about as likely as not to be correct" enquiry was correctly distilled by the Judge to "whether there is substantial merit in [the taxpayer's] arguments".[68] Expressed another way, the question is whether the taxpayer's argument would be seriously considered by a court. On that basis, Mr McKay submits the High Court judgment is a complete answer to any question of penalties. Mr McKay relies on the decision of Kós J in *Commissioner of Inland Revenue v John Curtis Developments Ltd* as supporting his proposition that, viewed objectively, the taxpayer's position must be regarded as one capable of being reasonably adopted and having substantial merit given it was found to be correct by the High Court.[69]

[107] We accept Mr McKay's submission. As the Supreme Court made clear in *Ben Nevis*, the inclusion of the word "about" in the test shows that a 50 per cent prospect of success is not the standard. Rather, the question is whether the merits of the arguments supporting the taxpayer's interpretation are substantial.[70] While we have come to a different conclusion from the High Court on the core tax avoidance

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68 High Court judgment, above n 5, at [221].

69 *Commissioner of Inland Revenue v John Curtis Developments Ltd* [2014] NZHC 3034, (2014) 26 NZTC 21-113 at [107].

70 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, above n 12, at [184].

issue, we are not persuaded that Frucor's arguments could be dismissed as lacking in substantial merit. Muir J, an experienced commercial Judge, not only regarded Frucor's argument as deserving of serious consideration, he explained in a careful, closely reasoned and comprehensive judgment why he was persuaded it was both factually and legally correct.

[108] Accordingly, we consider the Judge was correct to find that shortfall penalties should not have been imposed in this case.

Result

[109] The appeal is allowed.

[110] The orders made in the High Court are set aside. The interest assessments are reinstated. Shortfall penalties do not apply.

[111] The appellant is entitled to costs for a complex appeal on a band B basis and usual disbursements. We certify for second counsel.

[112] Costs in the High Court are to be determined by that Court in accordance with this judgment.

Solicitors:
Crown Law Office, Wellington for Appellant
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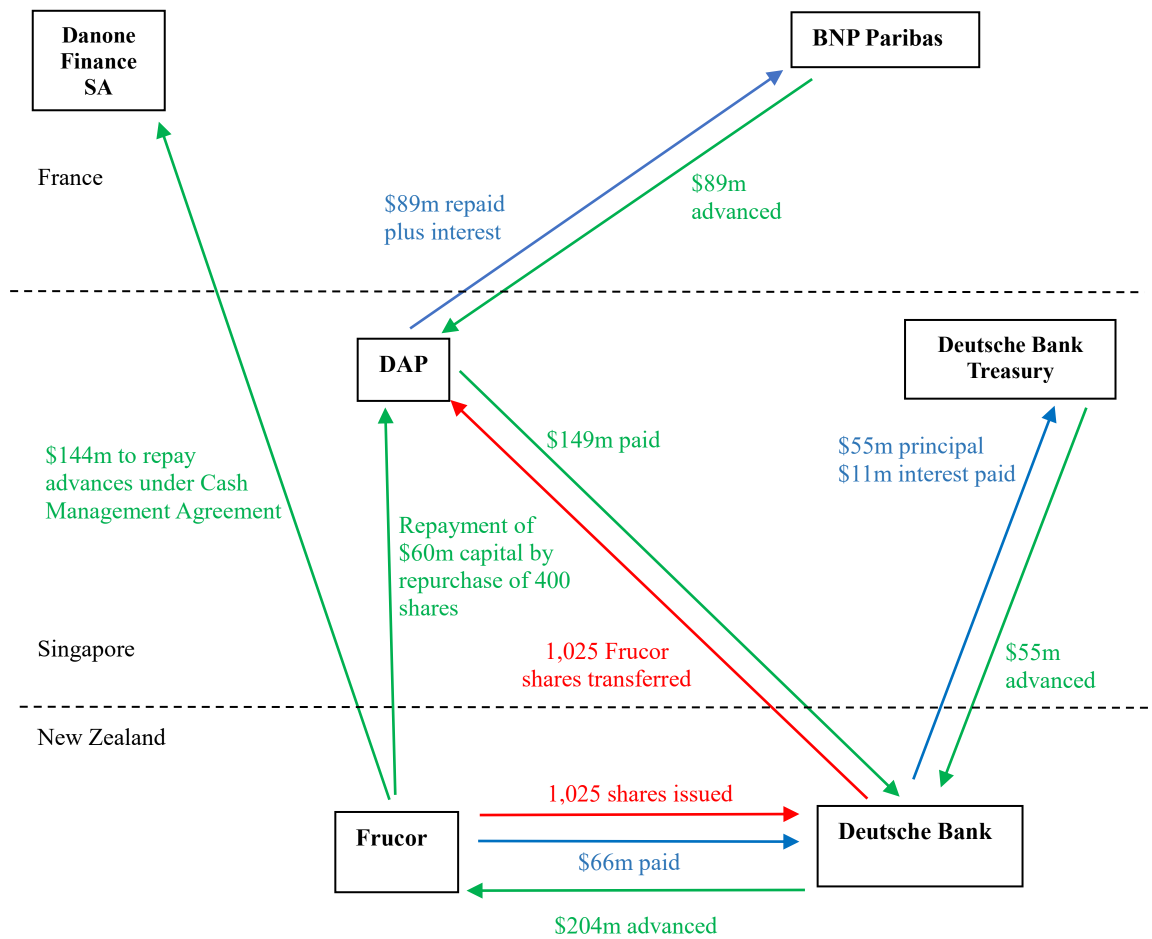
Appendix



Steps in Green: Occurred at commencement of funding arrangement in March—April 2003
Steps in Blue: Occurred over the term of the funding arrangement
Steps in Red: Occurred at maturity of funding arrangement in March 2008