Inland Revenue
Te Tari Taake

CASE SUMMARY

Supreme Court confirms Frucor's tax avoidance and finds shortfall penalties apply

Decision date: 30 September 2022

CSUM 22/05

CASE

Frucor Suntory New Zealand Limited v Commissioner of Inland Revenue [2022] NZSC 113

LEGISLATIVE REFERENCES

Income Tax Act 2004, ss BG 1 and GB 1.

Tax Administration Act 1994, ss 141B, 141D and 141FB.

LEGAL TERMS

Tax avoidance, shortfall penalties, unacceptable tax position, abusive tax position.

Summary

The Commissioner of Inland Revenue (Commissioner) disallowed interest deductions claimed by the predecessor of Frucor Suntory New Zealand Limited (Frucor) in respect of a tax-driven structured finance transaction it entered into in March 2003 involving associated companies and the Deutsche Bank.

The Commissioner contended that the funding arrangement was a tax avoidance arrangement in terms of s BG 1 of the Income Tax Act 2004 (ITA) and denied a portion of Frucor's claimed interest deductions in the 2006 and 2007 income tax years. The Commissioner also contended that Frucor took an unacceptable tax position and an abusive tax position such that shortfall penalties should be imposed.

Frucor challenged the assessments and was successful in the High Court, with that Court holding that the funding arrangement was not a tax avoidance arrangement. The Commissioner's assessments for 2006 and 2007 were thereby cancelled.

The Commissioner appealed and the Court of Appeal allowed the appeal, set aside the orders of the High Court, reinstated the Commissioner's assessments based on tax avoidance with regards to the disallowed deductions but held that shortfall penalties did not apply.

Frucor appealed the finding on tax avoidance and the Commissioner cross-appealed the finding that shortfall penalties did not apply.

The Supreme Court dismissed Frucor's appeal, finding there was tax avoidance and allowed the cross-appeal, finding shortfall penalties for taking an abusive tax position also applied.

Case Impact Statement

The decision of the Supreme Court confirms the legal framework for consideration of avoidance under s BG 1(1) of the ITA as articulated in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115. The Court did not signal that it was making a change in approach from that of the *Ben Nevis* Court.

In line with the Supreme Court's summarised reasons for finding tax avoidance, the Commissioner considers that using a tax provision allowing deductibility where the economic cost or burden has not been suffered will usually be outside Parliament's contemplation. In other words, where there is no expenditure incurred in an economic sense, Parliament would not have contemplated a deduction unless the specific provisions indicate otherwise. Artificiality and contrivance will reinforce such a conclusion.

Similarly, where an income provision does not apply but the economic benefits are enjoyed by the taxpayer, this too will usually be outside Parliament's contemplation.

The Supreme Court decision confirmed the Commissioner's broad powers to counteract any tax advantage from an arrangement deemed void in accordance with s BG 1 of the ITA through application of s GB 1 of the ITA. The Court also noted that consideration of counterfactuals as part of the counteraction process is permitted, but not mandatory.

The Commissioner considers that the Supreme Court's judgment on shortfall penalties is also an orthodox one and it does not alter the approach to determining whether an abusive tax position (ATP) shortfall penalty should apply. Shortfall penalties do not follow automatically from a finding of tax avoidance, and their applicability is a separate enquiry.

The enquiry under s 141D of the TAA for an ATP penalty firstly involves whether a taxpayer took an unacceptable tax position because, viewed objectively, the tax position failed to meet the standard of being about as likely as not to be correct. The Supreme Court clarified that it is not appropriate to replace the statutory "about as likely as not to be correct" test with a test of substantiality, based on the language used in *Ben Nevis*. Aside from this clarification, the Commissioner considers that the Supreme Court took an orthodox approach to determining whether a taxpayer has taken an unacceptable tax position.

If there is an unacceptable tax position, s 141D requires an ATP shortfall penalty if the arrangement was entered into with a dominant purpose of avoiding tax. In contrast, s BG 1 has a lower threshold, requiring an arrangement have a more than merely incidental purpose of avoiding tax.

The ATP penalty tests were considered satisfied on the facts as the Supreme Court found them to be, having also analysed the state of the law at the time the tax positions were taken. The Court considered the arrangement was based on a "generic tax-driven structure" developed by Deutsche Bank (which received a significant arranger fee) and the convertible note structure had no point, "leaving aside the purpose of obtaining tax advantages in New Zealand".

A discount of 50% under s 141FB of the TAA may apply in circumstances where the taxpayer has not previously had a penalty imposed.

Facts

Frucor entered into a funding arrangement, whereby Deutsche Bank advanced $204m to Frucor in exchange for a fee of $1.8m and a convertible note redeemable at maturity in five years' time by the issue of 1,025 non-voting shares in Frucor (the note).

The $204m advance by Deutsche Bank was funded by a contemporaneous payment of $149m from Frucor's parent, Danone Asia Pty Ltd (DAP), for the forward 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 $55m was contributed by Deutsche Bank.

Over the life of the note, Frucor paid $66m to Deutsche Bank and claimed the full $66m as interest payments on an interest only basis on $204m. The $66m coupon payments equated to the amount required to pay amortising principal and interest on the $55m introduced into the funding arrangement by Deutsche Bank.

Issues

The issues for consideration by the Supreme Court were:

- Whether s BG 1 of the ITA (the general anti-avoidance provision) was engaged?
- Whether the Commissioner's reconstruction under s GB 1(1) of the ITA, disallowing some of the interest deductions claimed, was correct? and
- Whether the tax positions adopted by Frucor were "unacceptable" on the basis that they did not meet the "about as likely as not to be correct" standard of s 141B of the TAA, and if so, whether they were also "abusive" on the basis that Frucor had acted with the "dominant purpose" of obtaining tax advantages (s 141D of the TAA).

Decision

Tax Avoidance

The Supreme Court summarised its reasons for finding the arrangement was a tax avoidance arrangement as follows:

> (1) Section BG 1(1) applies to tax arrangements (such as those associated with the note) which, but for its invocation, would have been effective in producing the desired tax advantage.
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> (2) Such application is justified if the tax advantage results from the use of a tax provision outside the parliamentary contemplation of that provision's purpose.
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> (3) Use of a tax provision intended to provide relief in relation to a particular economic burden (such as a cost, a loss or a reduction in income), where such a burden has not, in economic substance, been suffered, will usually lie outside of the relevant parliamentary contemplation. This is particularly so where such use is contrived and artificial.
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> (4) In this instance the tax provisions relied on by [Frucor] provide relief in relation to "interest incurred". In economic substance, however, the payments in respect of which [Frucor] sought the disallowed deductions were repayments of principal. The arrangements on which [Frucor] relied to categorise these principal repayments as

> interest were contrived and artificial. Deductibility for such repayments is not within the purpose of allowing deductibility for "interest incurred". Accordingly, [Frucor's] use of the deductibility provisions lay outside of the relevant parliamentary contemplation. This means that s BG 1(1) applies to void the arrangements.

Section GB 1

The Supreme Court found that because the purpose and effect of the tax avoidance arrangements were to provide deductibility for what in economic substance were repayments of principal, the Commissioner had correctly applied s GB 1(1) to adjust the taxable income of Frucor to disallow the deductions illegitimately claimed.

Shortfall Penalties

The Supreme Court noted, that in this case at least, the application of the "about as likely as not to be correct" standard must be taken against the background of the facts as the Court finds them to be.

Based on the facts as the Supreme Court found them to be, the tax positions adopted by Frucor did not meet that standard and were thus unacceptable. Further, Frucor acted with the dominant purpose of obtaining tax advantages with the result that the tax positions were abusive.

The Supreme Court found approaches taken to determining whether shortfall penalties should apply by the High Court and Court of Appeal were erroneous. The High Court erred because it determined the shortfall penalty question based on the facts as it found them to be, but the Supreme Court considered those factual findings to be wrong. The Court of Appeal did not seek to apply the "as likely as not to be correct standard" to the facts as it found them to be. Instead, it allowed its conclusion to be controlled by the result arrived at by the High Court Judge, despite not accepting his factual findings.

About this document

These are brief case summaries, prepared by Inland Revenue, of decisions made by the Taxation Review Authority, the District Court, the High Court, the Court of Appeal or the Supreme Court in matters involving the Revenue Acts. For Taxation Review Authority matters, names have been anonymized. The findings of the court described in a case summary will no longer represent current law where the matter has been successfully appealed or subsequent amended legislation has been enacted.