IN THE COURT OF APPEAL OF NEW ZEALAND

CA53/2012
[2013] NZCA 40

BETWEEN	ALESCO NEW ZEALAND LIMITED First Appellant
AND	PARBURY BUILDING PRODUCTS (NZ) LIMITED Second Appellant
AND	THERMO FISHER SCIENTIFIC NEW ZEALAND LIMITED Third Appellant
AND	ALESCO NZ TRUSTEE LIMITED Fourth Appellant
AND	CONCRETE PLUS LIMITED Fifth Appellant
AND	COMMISSIONER OF INLAND REVENUE Respondent

Hearing: 1, 2 and 3 October 2012

Court: O'Regan P, Harrison and White JJ

Counsel: L McKay, R G Simpson and M McKay for Appellants
B W F Brown QC, M S R Palmer and R L Roff for Respondent

Judgment: 5 March 2013 at 10 am

JUDGMENT OF THE COURT

A Alesco NZ's appeal is dismissed.

B Alesco NZ must pay costs to the Commissioner for a complex appeal on a band B basis and usual disbursements. We certify for two counsel.

REASONS OF THE COURT

(Given by Harrison J)

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Introduction

[1] In 2003 Alesco New Zealand Ltd (Alesco NZ) bought two other New Zealand companies. Its Australian owner, Alesco Corporation (Alesco), funded the acquisitions by advancing the purchase monies of $78 million. In consideration Alesco NZ issued a series of optional convertible notes (OCNs or notes). The notes

were non-interest bearing for a fixed term and on maturity the holder was entitled to exercise an option to convert the notes into shares. Between 2003 and 2008 Alesco NZ claimed deductions for amounts treated as interest liabilities on the notes in accordance with relevant accounting standards and a determination issued by the Commissioner against its liability to taxation in New Zealand. In the High Court Heath J upheld[1] the Commissioner's treatment of the OCN funding structure as a tax avoidance arrangement under s BG 1 of the Income Tax Act 1994 and the Income Tax Act 2004 (the ITA).[2]

[2] Alesco NZ appeals that finding and two consequential findings. The amount at issue is about $8.6 million. Included within that figure are revised assessable income tax, shortfall penalties and use of money interest. However, Alesco NZ's appeal has wider fiscal consequences. The Commissioner has treated similar funding structures used by other entities as tax avoidance arrangements. Decisions on those disputed assessments await the result of this litigation. The Commissioner estimates that over $300 million is at issue including core tax and penalties plus accruing use of money interest.

[3] Two other features of this appeal require emphasis. First, in contrast to a number of recent cases on tax avoidance,[3] the Commissioner does not impugn the underlying commercial transactions. She accepts that Alesco NZ's acquisitions were not made for the purpose or effect of avoiding tax and that the company had to raise funds to enable completion. Her challenge is to the permissibility of the OCN funding mechanism actually deployed or what is called an intermediate step in implementing the underlying transactions.[4]

[4] Second, the Commissioner accepts that when viewed in isolation from the statutory anti-avoidance provisions the OCN structure complied technically with the

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1 *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2012] 2 NZLR 252 (HC).

2 All statutory references in this judgment are to the Income Tax Act 1994 and the Income Tax Act 2004 unless otherwise stated.

3 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289; *Glenharrow Holdings Ltd v Commissioner of Inland Revenue* [2008] NZSC 116, [2009] 2 NZLR 359; *BNZ Investments Ltd v Commissioner of Inland Revenue* (2009) 24 NZTC 23,582 (HC); and *Westpac Banking Corporation v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834 (HC).

4 *Penny v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433 at [33].

relevant financial arrangements rules,[5] the deductibility provisions relating to expenditure[6] and interest[7] then in force, together with the spreading formula provided by the Commissioner's determination known as G22[8] (an instrument issued by the Commissioner to provide a method for assessing income and costs on debt instruments under the financial arrangements rules, to which we shall return in more detail).

[5] The meaning, purpose and effect of the financial arrangements rules, and the regime they introduced in 1985 for the purpose of assessing the income returns and deductibility of costs on particular debt instruments, are at the heart of this appeal.

Relevant facts

[6] Heath J's judgment recites the circumstances in comprehensive detail. However, the facts relevant to this appeal can be recorded in more truncated form.

[7] In January 2003 Alesco agreed to purchase for $46 million the shares in a New Zealand company, Biolab Ltd, a distributor of medical laboratory equipment. This sum was later increased to $55 million by a supplementary payment. Alesco nominated its New Zealand subsidiary, Alesco NZ, as the purchaser. While the purchase monies were to be raised in Australia, Alesco's board had not then decided on the appropriate funding structure.

[8] In early April 2003 Alesco NZ entered into an agreement to purchase for $28.653 million the assets of Robinson Industries Ltd, a producer and distributor of laundry tubs, kitchen air extractor systems and rangehoods. By then the appropriate funding structure had been settled.

[9] Alesco wished to structure Alesco NZ's funding of both acquisitions in the most tax effective way. In accordance with advice from KPMG in Australia and

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5 Part EH. These rules were previously known as the accrual rules. See Income Tax Act 1994, Part EH, Division 2 and Income Tax Act 2004, Subpart EW.

6 Section BD 2.

7 Section DD 1.

8 "Determination G22: Optional Conversion Convertible Notes Denominated in New Zealand Dollars Convertible at the Option of the Holder" (issued 24 October 1990). See at [16] and [73]–[83] below.

New Zealand, Alesco decided in February 2003 to use the OCN mechanism. Alesco's decision was implemented by Alesco NZ issuing three separate series of notes to its parent – for $41 million on 3 March 2003, $28 million on 14 April 2003 and $9 million on 1 September 2003.

[10] The OCNs were short form instruments issued pursuant to a subscription agreement. Materially the agreement provided that:

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

(b) no interest was payable on the notes;

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

(d) the notes were unsecured fully subordinated debt securities issued by Alesco NZ.

[11] Thus, in legal form and in economic substance Alesco made an interest free loan of $78 million to Alesco NZ to purchase the two other New Zealand companies. The agreement provided for two alternative means of repayment. One option was that on maturity of the notes in 10 years time Alesco would be entitled to increase its shareholding in Alesco NZ from 100,000 shares to 78,100,000 shares. However, the convertible option was of no practical value to Alesco given its total ownership of Alesco NZ and its associated power to increase its subsidiary's shareholding at any time.

[12] The other option was redemption of the loan in cash in 10 years time. Adoption of that course without any intervening right to interest would result in a significant economic cost or loss to Alesco. That factor, however, begs the question which lies at the heart of this appeal – did Alesco NZ also suffer an economic cost commensurate with its claimed deductions?

[13] KPMG's advice to use the OCN mechanism was based upon its creation of a product known as a "Hybrid Instrument into New Zealand" (HINZ). KPMG forecast tax benefits for Alesco NZ of between $3.4 million and $5.7 million on interest deductions available from using the HINZ to fund the two acquisitions. Alan Fonseca, Alesco's Group Financial Controller, explained the proposed OCN structure more fully to a board meeting on 17 February 2003. His memorandum advised as follows:

> **The nature of the convertible note**
>
> - On acquisition of Biolab (3 March 2003) Alesco NZ will issue 10 year convertible notes to Alesco Corporation Limited to the value of the purchase price.
>
> - Alesco NZ will use the proceeds of the convertible notes to pay the vendor for the shares in Biolab Ltd.
>
> - For accounting purposes in Aust and NZ we need to split the convertible note into the debt and equity components. As a result, Alesco NZ pays Alesco Aust interest which is calculated on the debt component of the convertible note.
>
> - For tax purposes, the Aust and NZ tax authorities treat the convertible note differently:
>
> - The Aust Tax Office views the convertible note as a 100% equity instrument and as such the interest received from Alesco NZ by Alesco Aust will not be assessable. Furthermore, the interest paid on the debt drawn down to finance the acquisition is tax deductible in Aust subject to thin capitalisation requirements.
>
> - The Internal Revenue Dept in NZ views the convertible note as a hybrid instrument and deems Alesco NZ to pay Alesco Aust interest at the market rate of a 10 year NZ govt bond (currently 6%). The interest paid by Alesco NZ is not subject to withholding tax and is tax deductible in NZ.
>
> **Utilisation of the interest deduction in Alesco NZ**
>
> - If Alesco NZ earns no income during the year it will make a tax loss equal to the interest deduction for the year. This loss can be transferred to other wholly owned Alesco companies within NZ eg. Biolab Ltd.
>
> - As a result we should get full utilisation of the tax credit in NZ.

[14] In summary, Mr Fonseca identified the three tax benefits available for Alesco NZ in New Zealand in implementing the OCN structure as (a) its ability to claim interest (even though it would not incur any such liability or in fact make any

such payments, contrary to the implication in the third bullet point in Mr Fonseca's memorandum) as a deduction from its accessible income; (b) the absence of liability for New Zealand non-resident withholding tax; and (c) an ability to transfer a tax loss equal to the notional interest deduction for a particular income year to other wholly owned Alesco companies in New Zealand. Alesco would gain a corresponding benefit in that it would not earn interest on the OCNs for which it would otherwise be liable to taxation in Australia. The OCNs' attraction lay in this asymmetrical cross border taxation treatment.

[15] Significantly, neither the subscription agreement nor the notes in fact allocated the principal sums between the two components of debt and equity (the share option) contemplated by Mr Fonseca's memorandum. Alesco's decision not to allocate or quantify these two components within the loan instrument is consistent with its satisfaction that the notes in their existing unallocated form would allow differing taxation treatments for the parties in Australia and New Zealand. At trial Mr Fonseca said this:

> The taxation treatment in Australia is not symmetrical to the position for financial reporting and New Zealand tax purposes. In Australia a 10-year OCN is treated as 100% equity for tax purposes. No debt component is recognised with the result that the deductible embedded funding cost recognised in New Zealand is not treated as taxable income in Australia. In this respect, the Australian tax treatment represents a departure from the correct financial reporting treatment for OCNs in Australia and New Zealand.

[16] After the funding transaction was implemented Alesco NZ applied for accounting and taxation purposes the method prescribed by G22[9] to:

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

(b) calculate the present value of all the cash flows by reference to a discount rate, which was the yield for New Zealand Government Stock of a similar term (that is, 10 years);

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9 See further at [73]–[83] below.

(c) treat the difference between the present value of the debt component ($38 million) and the cash redemption amount ($78 million) as the amount referable to the equity or share option element ($40 million) and as "expenditure incurred" within the financial arrangements rules; and

(d) treat the "expenditure incurred" as interest and deductible by Alesco NZ under the relevant statutory provisions.

[17] In its annual financial statements Alesco NZ progressively amortised or accumulated the discounted or present value of the debt component of $38 million so that at the end of the notes' projected 10 year term their value would show at $78 million. As recorded, this $40 million difference between the present and face values of the debt was equivalent to the equity or share option component as calculated by applying G22 and was also the amount treated annually as "expenditure incurred" which the company claimed as an interest deduction against its liability to income tax in New Zealand.

[18] The Commissioner was satisfied that the OCNs were arrangements entered into for the purpose or with the effect of tax avoidance and declared them void. She disallowed interest deductions claimed by Alesco NZ for "expenditure incurred" for the years between 2003 and 2008; reversed loss offset elections by companies within the Alesco NZ group in the years from 2003 to 2007; reassessed Alesco NZ's income tax for that period at $4.938 million; levied shortfall penalties of $2.469 million; and imposed a use of money interest liability of about $1.2 million.

[19] Heath J agreed with the Commissioner.[10] He found further that the Commissioner was not bound to reconstruct the arrangement to take into account or apply the next best alternative available to Alesco NZ to the arrangement actually implemented;[11] and that the shortfall penalties imposed by the Commissioner on

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10 At [147].
11 At [160].

Alesco NZ for taking an abusive tax position satisfied the relevant statutory criteria.[12]

[20] Alesco NZ appeals against all three findings. Its primary challenge is to Heath J's conclusion that the OCN mechanism was a tax avoidance arrangement: if that is successful, the other two findings will be rendered academic.

Issue 1: Tax avoidance

Introduction

(a) Principles

[21] In general terms, a tax avoidance arrangement is one which has tax avoidance as its purpose or effect or one of its purposes or effects if that purpose or effect is not merely incidental. Tax avoidance includes directly or indirectly avoiding or reducing any liability to income tax. Whether an arrangement satisfies these statutory criteria must be determined by undertaking this two stage enquiry mandated by the majority of the Supreme Court in *Ben Nevis*:

> [107] When, as here, a case involves reliance by the taxpayer on specific provisions, the first inquiry concerns the application of those provisions. The taxpayer must satisfy the court that the use made of the specific provision is within its intended scope. If that is shown, a further question arises based on the taxpayer's use of the specific provision viewed in the light of the arrangement as a whole. If, when viewed in that light, it is apparent that the taxpayer has used the specific provision, and thereby altered the incidence of income tax, in a way which cannot have been within the contemplation and purpose of Parliament when it enacted the provision, the arrangement will be a tax avoidance arrangement. For example, the licence premium was payable for a "right to use land", according to the ordinary meaning of those words, which of course includes their purpose. But because of additional features, to which we will come, associated primarily with the method and timing of payment, it represented and was part of a tax avoidance arrangement.

[22] In *Ben Nevis* the Court identified these particular factors which may assume relevance at the second stage of the inquiry:

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[12] At [180].

> [108] The general anti-avoidance provision does not confine the court as to the matters which may be taken into account when considering whether a tax avoidance arrangement exists. Hence the Commissioner and the courts may address a number of relevant factors, the significance of which will depend on the particular facts. The manner in which the arrangement is carried out will often be an important consideration. So will the role of all relevant parties and any relationship they may have with the taxpayer. The economic and commercial effect of documents and transactions may also be significant. Other features that may be relevant include the duration of the arrangement and the nature and extent of the financial consequences that it will have for the taxpayer. As indicated, it will often be the combination of various elements in the arrangement which is significant. A classic indicator of a use that is outside parliamentary contemplation is the structuring of an arrangement so that the taxpayer gains the benefit of the specific provision in an artificial or contrived way. It is not within Parliament's purpose for specific provisions to be used in that manner.
>
> [109] In considering these matters, the courts are not limited to purely legal considerations. They should also consider the use made of the specific provision in the light of the commercial reality and the economic effect of that use. 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.

[23] The Commissioner's approach to Alesco NZ's appeal renders the first stage of the tax avoidance inquiry unnecessary. As noted, she accepts Alesco NZ's technical compliance with the relevant financial arrangement provisions and determinations including G22; in other words the use made by the company of these specific provisions was within their intended scope. Mr Brown QC's argument is instead directed towards the second stage. He seeks to support Heath J's conclusion that when viewed in the light of the arrangement as a whole Alesco NZ used the relevant provisions in a way which was not within Parliament's contemplation and purpose.

[24] In view of the Commissioner's concession about technical compliance or satisfaction of the first stage of the tax avoidance inquiry we have not considered that issue and do not express an opinion upon it.

(b) Statutory provisions

[25] The ultimate question is whether the OCN arrangement had tax avoidance as its purpose or effect. It will be answered by inquiring whether Alesco NZ's use of the financial arrangements rules and G22 to alter the incidence of its group income tax, viewed in the light of the OCN arrangement as a whole, was within Parliament's contemplation and purpose. Commercial and economic realism is required. Artifice or contrivance can be hallmarks of tax avoidance.

[26] The relevant statutory provisions governing tax avoidance are well known. Section BG 1 provides that a tax avoidance arrangement is void against the Commissioner for income tax purposes. The critical definitions of "arrangement", "tax avoidance arrangement" and "tax avoidance" as found in s OB 1 are as follows:

> **OB 1 Definitions**
>
> **Arrangement** means any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect:
>
> **Tax avoidance**, in sections BG 1 ... includes–
>
> (a) Directly or indirectly altering the incidence of any income tax:
>
> (b) Directly or indirectly relieving any person from liability to pay income tax:
>
> (c) Directly or indirectly avoiding, reducing, or postponing any liability to income tax.
>
> **Tax avoidance arrangement** means an arrangement, whether entered into by the person affected by the arrangement or by another person, that directly or indirectly–
>
> (a) Has tax avoidance as its purpose or effect; or
>
> (b) Has tax avoidance as one of its purposes or effects, whether or not any other purpose or effect is referable to ordinary business or family dealings, if the purpose or effect is not merely incidental.

[27] Two aspects of the definitions are notable. First, the taxpayer's subjective motive or purpose is irrelevant to whether the impugned arrangement has "tax avoidance as its purpose or effect". This composite phrase refers to the objective which the arrangement sought to achieve or its end in view. The anti-avoidance

provisions are concerned with the purpose of the arrangement, not the purpose of the parties. Once a party's subjective purpose is put aside, the purpose of the arrangement is determined by considering its effect or what it has achieved; its purpose may be inferred from its effect. The Court then works backwards "... to determine what objectively the arrangement must be taken to have had as its purpose".[13]

[28] By reference to Alesco's primary documents generated in early 2003, Heath J was satisfied that Alesco NZ's sole motivation was to employ the most tax effective structure, whether in Australia, New Zealand or both.[14] Accordingly, the arrangement was necessarily one that directly or indirectly relieved the company from liability to pay income tax or reduced that liability through the ability to claim interest deductions and offset losses among group members.[15] This approach, was, with respect, in error. The enquiry must be confined to the contractual instruments – the subscription agreement and notes – and the effect achieved by Alesco NZ's use of the financial arrangements rules and G22.

[29] Second, the definition of a tax avoidance arrangement allows for two alternative approaches. One is where an arrangement has tax avoidance as "its purpose or effect", focussing on the sole, principal or dominant purpose or effect of the arrangement.[16] The other is of wider scope, allowing for inclusion of multiple purposes or effects. A tax avoidance purpose or effect must be more than merely incidental to any other purpose or effect to constitute statutory avoidance.

[30] In our judgment the use of the phrase "not merely" reinforces a conclusion that a tax avoidance purpose, if found, will offend s BG 1 unless it naturally attaches to or is subordinate or subsidiary to a concurrent legitimate purpose or effect.[17] Identification of a business purpose will not necessarily protect a transaction from scrutiny where tax avoidance is viewed as "a significant or actuating purpose which

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13 *Glenharrow*, above n 3, at [37]–[38].
14 At [16]–[20], [24].
15 At [91].
16 *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21,323 at [141].
17 *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA) at 533–534 per Woodhouse J; *Ben Nevis*, above n 3, at [113]–[114].

had been pursued as a goal in itself".[18] And, significantly, the case will be rare where use of a specific provision in a manner outside Parliament's contemplation might result in the tax avoidance purpose of the arrangement being merely incidental.[19]

(c) Arrangement

[31] While it was not in dispute before us, it is important to identify the nature and extent of the impugned arrangement within the meaning of s OB 1. It was common ground in the High Court that the notes themselves constituted the arrangement.[20] However, as both counsel accepted in this Court, the arrangement is of wider ambit. In summary the arrangement includes all steps taken for the purpose of implementing Alesco's investment in the notes including the relevant funding instruments – the subscription agreement and the notes – and, as Mr McKay submits, the cash flows themselves. Additionally, as Mr Brown submits, the arrangement included all incidental steps taken by Alesco NZ to claim the tax advantages such as completing the income tax returns. We emphasise that the statutory arrangement is distinct from the underlying commercial transactions constituted by Alesco NZ's acquisition of the two other New Zealand companies.

[32] The arrangement does of course rely on the deployment of the financial arrangements rules, the deductibility provisions relating to expenditure and interest and the spreading formula provided by G22. Before considering these specific provisions in more detail we must address a threshold argument raised by Mr McKay.

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18 *Tayles v Commissioner of Inland Revenue* [1982] 2 NZLR 726 (CA) at 736; *Westpac Banking Corporation*, above n 3, at [206] and [207].

19 *Ben Nevis*, above n 3, at [114].

20 At [91].

Threshold challenge: no liability to income tax avoided or reduced

(a) Alesco NZ's case

[33] Mr McKay submits that Alesco NZ did not directly or indirectly avoid, reduce or postpone "any liability to income tax". That is because its evidence establishes that Alesco would most likely have funded Alesco NZ by interest bearing loans from an Australian Alesco entity if the acquisitions had not proceeded by issuing OCNs. In that event the loans would have generated about twice the level of deductions in New Zealand. If Mr McKay's argument is correct, it is an absolute answer to the Commissioner's claim.

[34] Mr McKay submits that:

(a) A quantitative assessment is required of whether the impugned arrangement results in a reduction of New Zealand tax payable by regard to a reference point. Where arrangements alter an existing business or funding structure, it is not difficult to determine whether the arrangement has the effect of reducing post arrangement liabilities. However, where the arrangement represents a new business or funding activity, giving rise to deduction entitlements on a prospective basis, a different reference point is required.

(b) In this case, the question of whether the arrangement serves to relieve or reduce future tax liabilities can only be determined by regard to the tax position hypothetically obtainable under other business or funding structures (a counterfactual). An observation by Lord Wilberforce in *Mangin v Commissioner of Inland Revenue*[21] is authority for the proposition that because s BG 1 fails to define the nature of the liability to tax, avoidance of which is impugned, it must be one which might have arisen but for the arrangement. So determination of whether a liability to tax has been avoided requires a comparison

[21] *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 (PC) at 602 (Lord Wilberforce dissented) and referred to by Richardson J in *Challenge*, above n 17, at 551.

between the liability arising under an arrangement and the liability which would have arisen if Alesco NZ had entered into some other arrangement. That is the appropriate reference point.

[35] Alesco NZ relies on what Mr McKay calls Mr Fonseca's unchallenged evidence to establish its hypothetical or counterfactual. Mr Fonseca says that, but for the OCNs, Alesco would have "almost certainly" used an interest bearing loan to fund Alesco NZ's acquisitions. A mixture of interest bearing debt and direct equity or the unbundled equivalent of the OCNs were identified as possible alternatives. An identical level of deductions would have resulted on an interest bearing loan together with a liability for non resident withholding tax on interest as and when it was paid.

[36] Mr Brown counters that the OCN financing arrangements resulted in tax avoidance because they gave rise to tax deductions available to reduce tax payable by Alesco NZ or Alesco NZ group companies; it is unnecessary to perform a comparative or counterfactual analysis to establish tax avoidance; and, if such an analysis is required, the evidence established that funding by way of an interest bearing debt was unlikely to occur.

[37] We agree with Mr Brown. Mr McKay's argument falls, we think, at both hurdles.

(b) Legal ground

[38] First, we are not satisfied that Mr McKay's hypothetical can be sustained. The tax avoidance provisions are concerned with an actual arrangement. In this case the arrangement was constituted by the OCNs and the associated money flows. It was implemented from 2003 to 2008.

[39] The question is whether the particular arrangement had the effect of avoiding or reducing any liability to income tax. It is not whether Alesco NZ would have been equally able to avoid or reduce its liability by implementing an alternative and permissible arrangement. Contrary to Mr McKay's submission, we do not construe

the definition provisions as allowing for a hypothetical point of reference, based upon what might have happened if a taxpayer had chosen some years previously to structure its transaction differently.

[40] To adapt Lord Hoffmann's observation in *Miller*,[22] albeit in a slightly different context, the wording of the anti-avoidance provisions, when construed according to their text and purpose, does not allow a taxpayer to rewrite history by postulating an alternative arrangement once the one it has adopted is impugned.

[41] In this respect we do not construe Lord Wilberforce's obiter dissenting comments in *Mangin* as supporting Mr McKay's argument. In the course of identifying perceived deficiencies in the then current tax avoidance provision, s 108 of the Land and Income Tax Act 1954, Lord Wilberforce asked a series of rhetorical questions. One was whether the liability allegedly avoided was one "which must have arisen but for the arrangement".[23] This brief comment was made in the context of criticising a statutory failure to define the nature of the subject liability to tax, the avoidance of which was attacked. That dissenting criticism, however authoritative, is of no assistance to us in interpreting different statutory provisions in a different corporate context.

(c) Factual ground

[42] Second, Alesco's argument is without a reliable evidential foundation in any event. Mr McKay is correct that Mr Brown did not directly challenge Mr Fonseca on his reconstructed assertion that Alesco almost certainly would have funded the transactions in early 2003 by an interest bearing loan. And Mr McKay is correct that Heath J did not make a specific finding on this question, apparently because the argument has assumed more prominence in this Court. On appeal, however, we are able to review the evidence afresh and make our own findings, particularly where credibility is not in issue.

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22 *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 315 (PC) at [22].

23 *Mangin*, above n 21, at 602.

[43] In our judgment it is immaterial that Mr Brown did not challenge Mr Fonseca's evidence directly. Counsel's duties in cross-examination are now codified by s 92 of the Evidence Act 2006 as follows:

> **92 Cross-examination duties**
>
> (1) In any proceeding, a party must cross-examine a witness on significant matters that are relevant and in issue and that contradict the evidence of the witness, if the witness could reasonably be expected to be in a position to give admissible evidence on those matters.

[44] Section 92 is a rule of fairness, designed to ensure that a witness has an opportunity to answer any criticism of his or her evidence which may be made in closing argument. As this Court has previously observed, the provision relates to the concepts of challenge and confrontation of opposing witnesses which is central to the adversarial system – but its operation is not absolute.[24]

[45] Relevance is the source or touchstone of the duty to cross-examine; if the evidence is not relevant, it is not admissible[25] and nothing would be served by testing it. Mr Fonseca's evidence was not relevant because it had no probative value. His reconstruction was not based on facts but was a detailed rationalisation of events which never occurred. It was a speculative exercise conducted in an evidential vacuum and reads like a lawyer's argument on the relative merits of the possible alternatives. There would be no purpose in allowing Mr Fonseca an opportunity to answer these criticisms because the Court would have been unable to give any weight to his answers. At best his admissible evidence would have been limited to deposing to what the board actually considered by producing primary documents – board papers and minutes.

[46] Alesco NZ's production of a large number of primary documents leading to its decision to adopt the OCN structure reinforces this point. Heath J fully summarised them in a different context.[26] The documents refer only to the OCN structure. Alesco NZ did not produce any material which might either establish that the Alesco board considered alternative structures or support Mr Fonseca's assertion

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[24] *R v Dewar* [2008] NZCA 344 at [44]; *R v Soutar* [2009] NZCA 227 at [27].
[25] Evidence Act 2006, s 7.
[26] At [17]–[37].

that the absence of any Australian income tax liability for Alesco "... tipped the scales in favour of the OCNs over other forms of corporate funding to support the New Zealand acquisitions." It is a safe inference that from the outset the notes were the only funding arrangement being actively considered.

[47] If anything, Alesco NZ's documents contradict Mr Fonseca's assertion that the company would "almost certainly" have used an interest bearing loan. In June 2007 the Commissioner issued a Notice of Proposed Adjustment.[27] In August 2007 Alesco NZ submitted a detailed Notice of Response. In answer to the Commissioner's reconstruction of Alesco NZ's liability to tax, the company stated:

> The tax advantage must be measured against the tax consequences which would follow for Alesco NZ if it had entered into "Unbundled Transactions". It would have been quite open for it to issue a zero coupon note and, separately, an option in respect of which a premium was received. *The Unbundled Transactions must be the point of reference in determining whether a "tax advantage" has arisen for Alesco NZ.*[28]
>
> (Our emphasis.)

[48] Later in the same document Alesco NZ stated:

> Instead, what the Unbundled Transactions disclose is that an amount of "interest" would have arisen on the maturity of the zero coupon note .... While the Unbundled Transactions provide the point of reference to determine Alesco NZ's "tax advantage" from the "purported tax avoidance arrangement", *it may have also been the case that Alesco NZ funded itself by way of interest bearing debt*, to the maximum extent possible.
>
> (Our emphasis.)

[49] Alesco NZ's Notice of Response, prepared for the purpose of dissuading the Commissioner from a proposed course of action, undermined Mr Fonseca's evidence. In 2007 the company was advancing an unbundled transaction as the likely alternative to the OCNs. Interest bearing debt was mentioned only as a possibility. But by 2011 Alesco NZ through Mr Fonseca was asserting something materially different.

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[27] Tax Administration Act 1994, s 89B [the TAA].

[28] We discuss the "unbundled transactions" at [101]–[108].

[50] When pressed in cross-examination by Mr Brown on this inconsistency, Mr Fonseca passed practical responsibility on to KPMG which prepared the Notice of Response. His justification was his distraction by other work commitments at the time and a failure to pay the necessary attention to the Notice of Response. That was not a satisfactory explanation. Significantly, also, Mr Fonseca observed that "... it does appear that I am more forceful [now] in terms of interest bearing debt". The force or otherwise of Mr Fonseca's opinion is immaterial.

[51] It does not matter that hindsight exercised with the benefit of legal advice in 2011 suggests that interest bearing debt would have been the most fiscally beneficial funding alternative available to Alesco in 2003. It is not our function to assume that Alesco's board would have followed then what Mr Fonseca or Alesco NZ's lawyers now assert to be a commercially rational course when the issue never arose for consideration. In the result, even if Alesco NZ was able to advance a legal argument based upon a hypothetical or counterfactual analysis that the OCNs did not enable it to avoid or reduce its liability to income tax, it has failed to discharge its evidential burden. Its threshold challenge to the Commissioner's claim fails.

Tax avoidance in substance: competing arguments

[52] Alesco NZ's position is that the impugned arrangement did not have the requisite purpose or effect of tax avoidance. The company says that when viewed in a commercially and economically realistic way the OCN structure makes use of the relevant statutory provisions – the financial arrangements rules and G22 – in a manner consistent with Parliament's purpose. It points to these factors:

(a) the relevant statutory provisions correctly identify the economic substance of OCNs as involving debt and equity contributions from the subscriber and an economic cost to the issuer as the debt component increases in value to its face value – and a corresponding benefit to the holder which would be taxable if it was resident in New Zealand;

(b) the characterisation of the economic substance of the OCNs is supported by the almost identical treatment required to be adopted for OCNs for financial reporting purposes;

(c) a comparison of the relative tax benefits of the OCNs and interest bearing debt funding in New Zealand and Australia indicates that the true advantage of the OCNs was their non-normative treatment for Australian tax purposes; and

(d) Alesco NZ was entitled to select a tax enhanced form of a commercially envisaged transaction and its pursuit of these commercial objectives differentiates this case from others where s BG 1 has applied.

[53] The Commissioner disagrees and says that the application of the specific provisions to the OCNs is outside Parliament's contemplation because:

(a) the objective purpose of the OCNs was to alter the incidence of tax and there were non-tax benefits to using the OCNs;

(b) Alesco NZ suffered no real economic cost under the OCNs;

(c) Alesco NZ's treatment of the OCNs for financial reporting purposes is irrelevant to determination of their correct tax treatment;

(d) Alesco NZ's use of the OCNs was artificial and contrived because they contained unusual or unorthodox terms when compared to arm's length norms and had no point other than tax avoidance; they contained other terms designed to mimic those which might have been agreed between arm's length parties even though they had no purpose in this context; there was no true negotiation of the OCNs terms; the optional component of the OCNs served no commercial purpose as Alesco already held 100 per cent of the shares in Alesco NZ; and the option component of the OCNs was valueless; and

(e) in economic substance the OCNs were an interest free loan stapled to a valueless option.

High Court

[54] Heath J summarised the scheme and purpose of G22[29] and its relationship with the relevant accounting standards.[30] He considered the purpose of the financial arrangements rules.[31] This was within the tax avoidance analysis after taking into account the Commissioner's acceptance that Alesco NZ had claimed interest deductions to which it was entitled on a strict application of the financial arrangements rules including G22.[32]

[55] Heath J identified the question as being whether Parliament contemplated that the type of OCN transaction undertaken here would provide Alesco NZ with a right to deduct notional interest payments.[33] He was satisfied, among other things, that Alesco NZ did not incur a real interest expense on the notes and the notional interest claimed did not represent a real economic cost. The interest deductions claimed were not within Parliament's contemplation. He concluded that the company had made impermissible use of the statutory provisions[34] because of (a) the absence of a match between expenditure incurred and income to be returned; (b) the artificiality of a device designed only to secure a tax advantage; and (c) claiming a notional interest which did not represent a real economic cost.

Primary issue

[56] Having had the benefit of argument on appeal, we are able to narrow the scope of debate at this stage of the inquiry to what appears to be the one decisive question: that is, if it is established that Alesco NZ did not incur either a legal liability to pay interest or any economic cost on the loan, did its use of the financial arrangements rules and G22 to claim income tax deductions for expenditure incurred

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29 At [69]–[75].
30 At [76]–[80].
31 At [94]–[105].
32 At [88].
33 At [94].
34 At [146]–[147].

fall outside Parliament's contemplation when enacting the rules? Or, expressed slightly differently, did Alesco NZ obtain a tax advantage without bearing the interest expense which Parliament intended to be suffered in order to fall within the deductibility provisions?[35] Or, expressed differently again, should the anti-avoidance provisions be applied in a way which ignores the economic reality of the OCNs as contemplated by the deductibility provisions and G22?

[57] Heath J accepted the Commissioner's argument that the use of the OCNs was artificial and contrived because they were not the subject of negotiation and contained unusual or unorthodox terms when compared to arm's length norms and other terms designed to mimic orthodox convertible notes. However, we agree with Mr McKay that such an examination was of marginal assistance in determining the Commissioner's primary proposition. Thus it will be unnecessary for us also to review the particular issue which occupied considerable evidence and argument in the High Court of whether the option component of the notes had any economic value.

[58] We shall address Alesco NZ's challenge to Heath J's finding that its interest expenditure did not have real economic substance by separate reference to each of Mr McKay's five principal arguments.

Analysis of Alesco NZ's argument

(a) Determination G22

[59] First, as Mr McKay accepts, on its face each note constituted an unsecured interest free debt instrument. As a result Alesco NZ was not required to pay for the cost of borrowing and did not incur a legal obligation to do so. But, Mr McKay says, in accordance with Parliament's intention, the financial arrangements rules and G22 transformed the instrument for revenue purposes into one of real economic effect because they recognise or presuppose a genuine interest cost to the issuer. His argument stands or falls upon acceptance of this central proposition.

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35 *Ben Nevis*, above n 3, at [94].

[60] On Mr McKay's argument, the Commissioner's challenge to Alesco NZ's deduction entitlement denies the precise economic theory or principle that underlies financial reporting recognition and treatment of compound instruments. G22 adopts this principle. So when read in conjunction with the financial arrangements rules it signals a deliberate departure from taxation on the basis of legal form. Its purpose is to ensure that all gains and therefore expenditure from financial arrangements are taxed or deducted. It must be inferred that when formulating G22 the Commissioner as Parliament's agent or delegate adopted an analytical framework for determining the consequences of taxation treatment of OCNs which necessarily accepts there is a cost to the issuer of a nil coupon note.

[61] Mr McKay relies primarily on G22 without seeking to call in specific aid the financial arrangements rules. The statutory genesis of G22 is found in s 90(1)(g) of the Tax Administration Act 1994 (the TAA) as follows:

> **90 Determinations in relation to financial arrangements**
>
> (1) For the purposes of the old financial arrangements rules, the Commissioner may determine the following matters:
>
> ...
>
> (g) Where an excepted financial arrangement is part of a financial arrangement, the method for determining the part of—
>
> (i) The income, gain or loss, or expenditure:
>
> (ii) The acquisition price:
>
> (iii) The consideration receivable by the holder or payable by the issuer,—
>
> that is attributable to the excepted financial arrangement:

(i) Financial arrangements rules

[62] Section 90(1)(g) authorises the Commissioner to issue a determination about the method for determining that part of the expenditure which is attributable to an excepted financial arrangement as defined by the financial arrangements rules. In this case it is said to be the equity component of the option. Significantly, the Commissioner's power is to be exercised for the purpose of the financial

arrangements rules. It is ancillary or confined to that purpose and the terms of a determination such as G22 must be construed within that particular context.

[63] Our inquiry must therefore start with an assessment of the purpose or intended scope of the financial arrangements rules upon which Alesco NZ relied to claim interest deductions for expenditure incurred. Section EH 20 provides:

> **EH 20 Purpose**
>
> The purpose of this Division is to require parties to a financial arrangement to *accrue over the term of the arrangement* a fair and reasonable amount of income derived from, or *expenditure incurred* under the arrangement, and so prevent deferring income and advancing expenditure.
>
> (Our emphasis.)

[64] Heath J succinctly summarised the background to the financial arrangements rules as follows:

> [97] The [financial arrangements] rules are designed to deal with the taxation consequences of particular debt instruments. They create a regime dealing with the assessability and deductibility of financial returns or costs on debt instruments, without the need to determine whether a financial outlay should be classified as income or capital. The rules regulate the timing of the income returns and the claiming of deductible expenditure. An instrument that contains elements of both debt and equity is subject to the financial arrangement rules.

[65] The Judge also recited the relevant statutory provisions upon which Alesco NZ relied as follows:[36]

> **OB 1 Definition**
>
> Interest —
>
> (a) In relation to the deriving of gross income, resident withholding income, or non-resident withholding income by any person (in this definition referred to as the "first person"), *means every payment* (not being a repayment of money lent and not being a redemption payment), *whether periodical or not and however described or*

[36] Heath J set out the relevant provisions of the Income Tax Act 1994. The accrual rules are contained in Part EH Division 2 of the Income Tax Act 1994, comprising ss EH 19 to EH 59. Part EH was inserted by s 23(1) of the Taxation (Accrual Rules and Other Remedial Matters) 1999 with application to financial arrangements entered into as from 20 May 1999. The equivalent provisions in the Income Tax Act 2004, renamed the "financial arrangements rules", apply to tax derived in the 2005–2006 tax year and later tax years, and are set out in Subpart EW of that Act. We note that counsel principally referred to the 1994 Act on appeal in this Court, noting that there is no material difference between the provisions of these Acts.

computed, made to the first person by any other person (in this definition referred to as the "second person") in respect of or in relation to money lent to the second person making the payment or to any other person:

(Our emphasis.)

...

BD 2 Allowable deductions

Definition

(1) An amount is an allowable deduction of a taxpayer

...

(b) to the extent that it is an *expenditure* or loss

(i) *incurred by the taxpayer* in deriving the taxpayer's gross income, or

(ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or

(iii) allowed as a deduction to the taxpayer under Part ... D (Deductions Further Defined), E (Timing of Income and Deductions) ...

(Our emphasis.)

....

DB 1 Certain deductions not allowed

(1) Except as expressly provided in this Act, no deduction is allowed to a person in respect of any of the following sums or matters:

...

(e) Any tax, penalty, or interest payable under any enactment of any country or territory outside New Zealand imposing taxes, penalties, or interest on unpaid taxes, being a tax or penalty or interest which … in the opinion of the Commissioner, is substantially of the same nature as a civil penalty (as defined in section 3(1) of the Tax Administration Act 1994) or a criminal penalty imposed under Part 9 of the Tax Administration Act 1994, or interest imposed under Part 7 of that Act.

DD 1 Certain deductions not permitted – rents, interest, and premises

(1) Except as expressly provided in this Act, no deduction is allowed to a taxpayer in respect of any of the following sums or matters:

...

(b) *Interest* (not being interest of any of the kinds referred to in section DB 1(1)(e) and not being interest to which section LF 7 applies to prohibit a deduction), *except so far as …*

(i) *It is payable* in deriving the taxpayer's gross income; or

(ii) It is necessarily payable in carrying on a business for the purpose of deriving the taxpayer's gross income; or

(iii) It is payable by one company included in a group of companies in respect of money borrowed to acquire shares in another company included in that group of companies:

Provided that for the purpose of this paragraph *expenditure incurred under the accrual rules is treated as interest payable*:

Provided further that for the purposes of this paragraph any 2 companies shall be treated as being included in a group of companies in respect of any income year only if those companies are members of the same group of companies at the end of that income year:

...

(3) Subject to section DB 1(1)(e) and despite subsection (1)(b), *expenditure on interest is an allowable deduction of a company*.

(4) In subsection (3)—

a company does not include—

...

(d) a non-resident company, except to the extent that the company incurs expenditure on interest in the course of carrying on a business through a fixed establishment in New Zealand

interest includes expenditure incurred under Part EH.

(Our emphasis.)

EH 22 Financial arrangement defined

Definition

(1) A financial arrangement is

(a) a debt or debt instrument, including a debt that arises by law;

(b) an arrangement (that may include a debt or debt instrument or an excepted financial arrangement) under which a person receives money in consideration for a person providing money to any person

(i) at a future time, or

(ii) when an event occurs in the future or does not occur (whether or not the event occurs because notice is or is not given)

...

Excepted financial arrangement excluded

(4) Despite subsection (1)(b), an excepted financial arrangement is not itself a financial arrangement unless the excepted financial arrangement is part of another arrangement that satisfies subsection (1)(b).

EH 23 Excepted financial arrangement part of financial arrangement

...

Accrual rules apply

(2) An amount of income, gain, loss, or expenditure that is solely attributable to an excepted financial arrangement that is part of a financial arrangement and excepted under section EH 24(1)(b), (j), (l), (n), (p), (q), (t), or (u) is income or expenditure under the accrual rules.

EH 24 Excepted financial arrangement defined

Definition

(1) An excepted financial arrangement is

...

(o) shares or an option to acquire or to sell shares, ...

...

[66] Section EH 47 is also relevant. That is because the question in this case must be whether Alesco NZ incurred "expenditure" in terms of s EH 47(2)(b) and was thus prima facie entitled to the deductions claimed:

EH 47 Base price adjustment – calculation

…

Result of adjustment is income or expenditure

(2) If the result of the base price adjustment

(a) is a positive amount, the result is income derived by the person in the income year, and

(b) is a negative amount, the result is expenditure incurred by the person in the income year.

(ii) Purpose and effect of the financial arrangements rules

[67] Susan Glazebrook and others *The New Zealand Accrual Regime – A Practical Guide* describe the principal aims of the rules in their 1999 revision as follows:[37]

> ... first, to ensure the matching between the parties to a transaction of income and expenditure recognition for tax purposes and to require that income and expenditure be spread over the term of the arrangement; secondly, to dilute (and, in some cases, abolish) the capital/revenue distinction to ensure that all returns on financial arrangements, a term which is widely defined, are taxable; and, thirdly, to ensure more consistency between financial accounting and tax accounting.

[68] In *Commissioner of Inland Revenue v Auckland Harbour Board*[38] the Privy Council cited with approval the following passage from Glazebrook and others *New Zealand Accrual Regime*:[39]

> [The traditional] legal/accounting approach to defining what constitutes income can be compared with an economic approach. Under economic principles all gains in wealth are generally considered to be "income" and all reductions in wealth are subtracted from income. Whether any "gain" or "loss" can be categorised as capital or revenue assumes no relevance, the only issue is whether there is an overall gain or loss of wealth over the period for which the income is being measured.
>
> The accrual regime can be interpreted as a fundamental shift from the rest of the income tax regime which operates on traditional legal/accounting principles. It is a move to a regime where the Act operates more on economic principles.

[69] In *Auckland Harbour Board* the Board described the regime's general scheme as being "to tax the holder of the arrangement on his entire cash inflow less his entire cash outflow".[40] And in *Commissioner of Inland Revenue v Dewavrin Segard (NZ) Ltd*[41] this Court noted that the broad purpose or object of the rules was, among other things, to:

> Allow deduction of expenditure across the term of financial arrangements in which they are ... incurred.

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37 Susan Glazebrook and others *The New Zealand Accrual Regime – A Practical Guide* (2nd ed, CCH New Zealand, Auckland, 1999) at [102].

38 *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (PC) at [2].

39 An earlier edition of the text was cited: Susan Glazebrook and others *The New Zealand Accrual Regime – A Practical Guide* (CCH New Zealand, Auckland, 1989) at [301].

40 At [13].

41 *Commissioner of Inland Revenue v Dewavrin Segard (NZ) Ltd* (1994) 16 NZTC 11,048 (CA).

As the Court also noted, the rules were designed to avoid the loading of expenditure when the arrangement commenced.

[70] The concepts of "expenditure" or "expenditure incurred" are central to determining whether a particular funding transaction falls within the purview of the financial arrangements rules. Neither phrase is defined anywhere in this part of the Act. But on its plain meaning within its statutory context the word "expenditure" requires an actual outflow of or parting with money or an obligation to make payment. (Mr McKay is correct that in other taxation contexts such as depreciation rules a cash cost is not necessary to recognise an expense.)

[71] In our judgment, the financial arrangements rules were intended to give effect to the reality of income and expenditure[42] – that is, real economic benefits and costs. They were designed to recognise the economic effect of a transaction, not its legal or accounting form or treatment. The question is whether the taxpayer has "truly incurred the cost as intended by Parliament".[43] This construction is reinforced by the relevant addition, in three critical provisions,[44] of the word "incurred". In the *Mitsubishi Motors*[45] case the Privy Council affirmed, with reference to an earlier statutory provision, that expenditure is incurred on the premise that it arises pursuant to a legal obligation.

[72] These features suggest that Parliament did not intend that a taxpayer would be entitled to use the financial arrangements rules as a basis for claiming deductions for interest for which the taxpayer was not liable or did not pay. The rules were intended to operate as a net regime – that is to bring to tax the amount yielded after deducting the entire economic cost from a taxpayer's entire economic benefit. In the absence of a liability a taxpayer claiming the benefit of a deduction for interest payments would be purporting to incur that liability without suffering the economic

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42 *Challenge*, above n 17, at 558.

43 *Peterson v Commissioner of Inland Revenue* [2006] 3 NZLR 433 (PC), approved in *Ben Nevis*, above n 3, at [98] and [127].

44 Sections EH 20, BD 2(1)(b)(i) and DD 1(1).

45 *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Ltd* [1995] 3 NZLR 513 (PC).

burden.[46] We are satisfied that the intended purview of the rules is to exclude notional transactions.

(iii) Analysis of G22

[73] G22 must be considered within the framework of our conclusion that Parliament introduced the financial arrangements rules for the purpose of allowing income tax deductions for real economic costs incurred. It is essentially a prescriptive instrument introduced, as we have observed, to provide a method or mechanism for allocating liabilities under the rules. G22's explanatory introduction opens with acknowledgments that a convertible note is a financial arrangement having debt and equity components. The equity component is the option which is an excepted financial arrangement.

[74] The explanation goes on to say:

> (3) Thus, when calculating income or expenditure as it relates to a Convertible Note, it is necessary to separate the debt and equity components of the note. This is done for two purposes:
>
> (a) Firstly, this determination sets out the method to separate the acquisition price into debt and equity components for the purpose of calculating income or expenditure during the term of the note; ...
>
> (b) Secondly, the determination sets out the method for separating the amount of the consideration payable by the issuer or receivable by the holder into debt and equity components as required for the base price adjustment. This is done in three stages ...

[75] Clause 4 expands on the explanation in these terms:

> **4. Principle**
>
> (1) An optional conversion Convertible Note is a hybrid financial arrangement which has a debt and an equity component. The equity component is an option to acquire or to sell shares. Options to acquire or to sell shares are excepted financial arrangements.
>
> (2) This determination sets out the method for determining the part of the acquisition price and the part of the consideration receivable by the holder or payable by the issuer that is attributable to the excepted financial arrangement. These amounts, if any, are not taken into account in any calculations to determine income derived or

[46] *Peterson*, above n 43, at [42] per Lord Millett; *Ben Nevis*, above n 3, at [116]–[120].

expenditure incurred or the base price adjustment under sections 64B to 64M of [the Income Tax Act 1976].

(3) The effect of this determination is that the holder and issuer of the Convertible Note are taxed as if the Convertible Note were a bond, issued at a price which excludes an amount paid or received for the option to convert to shares, and redeemable at the Cash Redemption Amount with Coupon Interest Payments throughout the term of the note if applicable.

(4) It is assumed that a person will not forgo a cash payment where the value of the alternative is less than the amount of the cash payment; and in particular a person will elect to receive cash rather than shares unless the value of the shares is greater than the amount of the cash payment available, in which case the excess is attributed to the excepted financial arrangement.[47]

(5) It is assumed that a person will not suffer a net loss in order to give any other person the right to create a claim over the first mentioned person; and in particular a company will not pay any person to take up a call option on the company for the company shares.

[76] Once the excepted financial arrangement is identified and severed, the balance, being the debt component and its attributable income or expenditure, is subject to tax. The equity component – or share option – and all income or expenditure attributable to it are excepted from liability to tax. Alesco NZ calculates the amount of that latter component at $40 million. As the explanation states:

(7) The effect of this determination is that the holder and issuer of the Convertible Note are taxed as if the Convertible Note were a bond which:

(a) Is issued at a price which excludes an amount paid or received for the option to convert shares (equity component);

(b) Is redeemable in cash (the Cash Redemption Amount);

(c) May have Coupon Interest Payments paid during the term of the note.

[77] Mr McKay's argument relies heavily upon technical compliance with G22. He says that G22 requires the holder of an OCN to recognise income as the discounted debt component grows to face value. His constant assumption is that Alesco NZ's calculation of the debt component and of the attributable interest notionally paid to Alesco in accordance with G22 was sufficient to bring its claim

[47] We record that neither counsel addressed argument on the effect, if any, of this Principle.

within the purview of a lawful deduction under the financial arrangements rules. His argument eschews acceptance of the indisputable purpose and effect of the rules.

[78] This approach is, in our judgment, diversionary. The OCNs are a financial arrangement. G22 is no more than the Commissioner's prescription for severing and calculating the amount of Alesco NZ's obligation attributable to the excepted financial arrangement – that is the equity element of the OCNs constituted by the share option. Its legal status and effect is limited to providing the appropriate methodology for that purpose. It is not determinative of the underlying question of whether notional interest deductions claimed on the debt component of the instrument amount to "expenditure" or "expenditure incurred" in terms of the financial arrangements rules.

[79] G22's recognition that a borrower may incur an interest cost on the debt or coupon component of the OCN is hardly surprising. That assumption underlies, for example, cl 4(3) which provides:

> The effect of this determination is that the holder and issuer of the Convertible Note are taxed as if the Convertible Note were a bond, issued at a price which excludes an amount paid or received for the option to convert to shares, and redeemable at the Cash Redemption Amount with coupon interest payments throughout the term of the note if applicable.

[80] The Cash Redemption Amount in this case is the face value of the bond of $78 million. Coupon interest payments on a Convertible Note mean:

> ... any amount or amounts *payable on the note* by the note issuer to the note holder other than the cash redemption amount.

[81] G22 presupposes that "amounts payable on the note" will be a genuine cost because that it is the commercial norm. While it is not the norm for a taxpayer to receive a substantial interest free loan, G22 recognises that some notes may not be interest bearing. We will return more fully to this issue when addressing the unbundling argument advanced by Mr McKay.[48] However, G22's recognition that interest will be payable on some notes but not others does not mean that both have an identical fiscal effect.

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[48] At [92]–[108] below.

[82] Mr McKay's argument is expressed in a number of ways by reference to a number of examples. But it always returns to the same essential starting point – that G22 transforms the fiscal effect of the absence of an obligation to pay interest to a real economic cost incurred by Alesco NZ on these notes of $40 million. However, something more would be necessary to persuade us that words can turn a negative into a positive or a pretence into a reality. The terms of G22 do not alter our conclusion that Alesco NZ did not incur a real economic cost on the OCNs of the type contemplated by Parliament when providing for interest deductions under the financial arrangements rules. G22 speaks for itself in answer to Mr McKay's argument.

[83] In summary, to paraphrase what was said by Lord Templeman in *Challenge*[49] and adapted by the Supreme Court in *Penny*,[50] Alesco NZ did not actually pay interest or suffer an analogous liability but obtained a reduction in liability to tax as if it had. To the same effect was this Court's satisfaction in *Accent Management Ltd* (*Ben Nevis* in the Supreme Court)[51] that the underlying premise for the statutory deductibility rules is that they are to apply only when real economic consequences are incurred. Alesco NZ did not as a matter of fact incur an expenditure or a liability for it within the meaning of s DD 1 of the Act. That was a fiction adopted solely for income tax purposes.

(b) *Rossiter v Commissioner of Inland Revenue*

[84] Second, Mr McKay relies upon this Court's decision in *Rossiter v Commissioner of Inland Revenue.*[52] He submits that:

> (a) In *Rossiter* a loan for a fixed term on a nil interest basis was treated for gift duty purposes in accordance with its economic substance, as being made for fully adequate consideration to the extent of the discounted present value of the debt and as being a gift of the difference between the present and face values.

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49 *Challenge*, above n 17, at 561.
50 At [47].
51 *Accent Management Ltd*, above n 16, at [126].
52 *Rossiter v Commissioner of Inland Revenue* [1977] 1 NZLR 195 (CA).

(b) It would be incongruous if the economic gain derived by the recipient of an interest free loan for a fixed term was regarded as sufficiently substantive to be the subject of a gift duty liability on that gain, yet the economic cost represented by that party's ultimate obligation to repay the face value was not regarded as a real or actual economic cost at all. If viewed from an economic stand point, that cost comes home to the borrower over the period between the dates of the loan's advance and repayment.

(c) On a comparative basis Alesco NZ received $78 million under the OCNs but the terms constituted a present value debt liability of $38 million. Nevertheless, its obligation to repay the $78 million either in cash or shares equivalent remained. Over time, its present value liability of $38 million accrued to that $78 million level. That increase in obligation reduced the net asset position of the issuer and was in every sense a real economic cost to it.

[85] However, we are not satisfied that *Rossiter* assists Mr McKay. The question for determination in that case was whether a largely interest free loan constituted a gift under the Estate and Gift Duties Act 1968. That question and its statutory framework are remote from a claim that an OCN financing structure constituted a tax avoidance arrangement under the ITA.

[86] More specifically, in *Rossiter* a father loaned his son a substantial sum to enable him to purchase the family farm. The term was for 10 years interest free. Self-evidently, as this Court noted, the right to receive a fixed sum at a future date is less valuable than the right to immediate payment. To the extent that the lender had foregone a right to interest over the period of deferment, the consideration for the loan was inadequate and constituted a gift for statutory purposes. The gift was quantified by the standard method of applying a discounted interest rate over the agreed term.

[87] *Rossiter* does not exemplify a principle of far reaching economic consequence. The result and its quantification could hardly have been more

orthodox. Contrary to Mr McKay's argument, the difference between the two values in that case, represented by the amount of the gift, did not add a cost or liability to the borrower. Like Alesco NZ, the borrower did not assume the ultimate economic burden of repaying the uncharged interest. His obligation remained constant and was limited to repayment of the principal only. An assessment of the discounted present value of the loan giving rise to the liability for gift duty, related to the loss suffered by the lender, not by the borrower. Any analogy between *Rossiter* and this case lies in its recognition, adverse to Mr McKay's argument, that Alesco as the lender carried the true economic cost of an interest free loan – not the reverse.

[88] Mr McKay's reliance on *Rossiter* reflects the circularity of his argument. It all comes back to where it started with his assertion that the increase in Alesco NZ's notional liability between the present and face values of the debt component of the OCNs, calculated according to the G22 methodology, is a real or actual expense. That proposition requires us to accept that G22 transforms a notional interest cost into a real interest cost for fiscal purposes. We are satisfied that it does not and that it was never intended to have that purpose.

(c) International Financial Reporting Standards (IFRS) and Generally Accepted Accounting Principles (GAAP)

[89] Third, Mr McKay relies on the IFRS and GAAP. He says those standards apply settled principles to hybrid instruments like OCNs. In particular, they recognise the practice of discounting a term liability to determine its separate debt and equity components; and treating as an expense accretion the face value of debt after its initial quantification. The obligation to take an interest charge against profits based on the cost of funds on the issue of a non or low interest bearing OCN presumptively suggests that in terms of accounting theory an economic cost does indeed exist or arises on the issue of such an instrument. When an expense is raised in financial statements prepared on an economic and substantive basis, that expense suggests that such a cost exists in economic terms. A convertible note expense has an identical impact on the net financial performance of the issuer to interest paid.

[90] Mr McKay properly accepts that the accounting treatment of a transaction cannot dictate its taxation treatment; and that the IFRS and GAAP would not on their own carry the day for Alesco NZ. At best it is, as he observes, relevant to the extent of corroborating the economic logic of the taxation treatment prescribed in G22.

[91] Given our rejection of Mr McKay's primary argument, it follows that we reject this submission. In this respect we endorse Heath J's conclusions that:

> [119] The debate over the appropriate accounting treatment was somewhat arid. As long as the true nature of the transaction was disclosed to readers of Alesco NZ's financial statements, the reporting requirements were satisfied. Alesco NZ did, in fact, disclose the true position. This was done by differentiating between interest paid as a cash outgoing and amortised interest costs.
>
> ...
>
> [121] Disclosure of the true nature of the transaction does not necessarily mean that the cost reflected in the amortised interest had real economic substance or that it was the type of cost that Parliament had contemplated would fall within the financial arrangement rules. Compliance with the requirement to present a true and fair view of a company's financial position does not determine whether a transaction reported in accordance with generally accepted accounting practice is capable of securing a "permissible" tax advantage.

(d) Expert evidence

[92] Fourth, Mr McKay relies primarily on expert evidence to support his argument that Alesco NZ incurred a real economic cost under the OCNs for which it properly claimed deductions.

[93] It is necessary to comment at this juncture on the growing reliance on opinion evidence in tax avoidance cases. Section 25 of the Evidence Act contains a concise summary of the purpose of expert evidence:

> **25 Admissibility of expert opinion evidence**
>
> (1) An opinion by an expert that is part of expert evidence offered in a proceeding is admissible if the fact-finder is likely to obtain substantial help from the opinion in understanding other evidence in the proceeding or in ascertaining any fact that is of consequence to the determination of the proceeding.

[94] This country's tax avoidance jurisprudence is characterised by its authoritative and constant emphasis on the centrality of findings of fact made according to the relevant statutory principles. In *Elmiger v Commissioner of Inland Revenue*,[53] North P stated what may then have seemed trite that whether a transaction is a tax avoidance arrangement is "... ultimately a question of fact". The same fundamental point has since been made time and again and is true for all disputed claims of tax avoidance.[54] The intensely factual focus of the inquiry reflects the need to identify the elements of the impugned arrangement and, objectively, its purpose and effect while taking into account its economic substance rather than being limited to an assessment of its legal form.

[95] A central question in this case is whether in circumstances where the financial instrument imposed no obligation to pay interest Alesco NZ nevertheless in fact incurred a real economic cost on the OCNs justifying a deductible expense. The touchstone for the admissibility of opinion evidence is whether the Court is likely to obtain substantial assistance from an expert in ascertaining that fact.

[96] We accept that, in cases where the impugned arrangement falls within a novel or sophisticated economic environment, independent expert assistance may assist the Court to understand the necessary factual context including the commercial effects and economic substance of a transaction. The structured finance transactions are an example.[55] But Alesco NZ's case is not in that category. The elements of the OCN transactions are relatively straightforward and readily understood from the primary documents with explanatory assistance, if required, from a principal witness. Opinion evidence is unnecessary for that purpose.

[97] Events at the trial in this case reflect an increasing but unacceptable trend of resorting to experts to add to the armoury of advocacy. Moreover, as the transcript reveals, much of that opinion evidence lacked the necessary objectivity. As s 26 of

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53 *Elmiger v Commissioner of Inland Revenue* [1967] NZLR 161 (CA) at 178.

54 Examples are *Marx v Commissioner of Inland Revenue* [1969] NZLR 464 (SC) at 467; *Commissioner of Inland Revenue v Ashton* [1974] 2 NZLR 321 (CA) at 322; *Challenge*, above n 17, at 558; *Peterson*, above n 43, at [47]; and *Commissioner of Inland Revenue v BNZ Investments Ltd* [2002] 1 NZLR 480 (CA) at [37] and [56].

55 *BNZ Investments Ltd v Commissioner of Inland Revenue*, above n 3; *Westpac Banking Corporation*, above n 3.

the Evidence Act reaffirms, when giving evidence experts are expected to conduct themselves in accordance with the applicable rules of court including the fundamental obligation of impartiality.[56] However, at trial Alesco NZ used its expert evidence to launch hypotheses which were unrelated to the facts of this case. The result did not assist the Court, but added unnecessary complication by diverting the true nature of the enquiry away from the facts down unproductive paths into a trial by experts.[57]

[98] In this respect we refer principally to Mr McKay's reliance on Michael Schubert's evidence. He is a chartered accountant and a partner in the New Zealand accounting firm, PricewaterhouseCoopers. His brief and the cross-examination it generated of the Commissioner's witnesses exemplify our criticisms. Originally Mr Schubert was engaged to provide an opinion on the correct financial reporting treatment of the OCNs. To support his advice that Alesco NZ's accounting treatment of the transaction represented economic reality, Mr Schubert said this:

> If we take the total cash obligation required in just over 10 years' time to extinguish the debt ($78 million) and subtract the fair value of the debt component at inception ($38.6 million), we are left with approximately $39.4 million. Simply stated, this difference of $39.4 million is the overall economic cost of the debt (in other words, it is the total interest cost of the debt) which will need to be borne by Alesco NZ and spread over the term of the OCNs. It represents the difference between the fair value of the debt at the time the OCNs were issued and the cash amount that would ultimately be required to extinguish the debt.
>
> The total economic cost of the debt is a charge against earnings. Each year, ignoring the effect of all other transactions, as the debt accretes and approaches the maturity amount, both the net assets and equity of Alesco NZ reduces (because the debt increases). ... This overall economic cost will have an aggregate negative impact on the net assets of Alesco NZ by the same amount.

[99] This view is, we must say, reflective of a narrow, accounting based approach which depends for its acceptance upon ignoring economic reality. Professor Stewart Jones, a Professor of Accounting at the University of Sydney who was called by the Commissioner, properly condemned it as "fictitious". In similar vein, John Hagen,

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[56] *Penny*, above n 4, at [32]; *Westpac Banking Corporation*, above n 3, at [46]–[49].

[57] *Commerce Commission v Telecom Corporation of New Zealand Ltd* [2009] NZCA 338, (2009) 12 TCLR 457 at [31].

an experienced New Zealand chartered accountant and company director also called by the Commissioner, described the expense as "pseudo interest".

[100] As Mr Hagen explained, an accretion of the present value of debt to maturity only reflects a reduction by an amount equal to the amount of the share option component of the notes, calculated not according to its legal character but by the terms of G22. Alesco NZ received $78 million for issuing the notes and was contractually obliged to repay the same amount in 10 years time. But it had no liability to pay interest in the interim. It defies economic reality to opine that the amount allocated to the share option of $40 million, where that allocation was not required by the instrument but was done purely to satisfy a perception of G22, was equivalent to the total overall interest cost of the debt.

[101] Mr Schubert also advanced what at trial Alesco NZ's counsel called a "developing hypothetical". It was of Alesco NZ issuing a third party lender a 10 year zero coupon bond with a face value of $78 million issued for $38 million plus options or shares for a subscription price of $40 million. Mr McKay notes the Commissioner's acknowledgment that an unbundled transaction of this nature would have allowed Alesco NZ a deduction entitlement for interest of $40 million, being equivalent to the difference between the discounted issue price of $38 million and face value of $78 million. On this approach, according to Mr McKay, it cannot be said that Alesco NZ suffered no economic cost under the OCN transactions when from any substantive or economic viewpoint its position pursuant to them was precisely the same as the unbundled transactions. In essence, he says, the unbundled instrument is the economic equivalent of the OCNs.

[102] Mr McKay relies on what he says were concessions made by Professor Jones and Mr Hagen that on Mr Schubert's developing hypothetical Alesco NZ would incur an economic interest cost over the life of the $40 million bond. But the context of the answers given by both experts in cross-examination and the reasons for their acceptance of this proposition only serve to illustrate both the futility of hypotheticals in this type of case and, more significantly, the untenability of Alesco NZ's position on the OCNs.

[103] Mr Schubert's developing hypothetical had no evidential value because it failed to compare like with like. The OCNs were financing instruments comprised of the subscription agreement with notes attached. Critically, as earlier noted, the instruments made no distinction between the legal elements of debt and equity. That separation exercise was only carried out by Alesco NZ subsequently for revenue and accounting purposes to provide a foundation for claiming deductions by reliance on G22 and satisfy the IFRS and GAAP. As Professor Jones aptly observed, the OCN was a zero coupon bond with a conversion feature which had to be accounted for under the IFRS.

[104] Mr Schubert's hypothetical postulated a markedly different instrument. It had correspondingly different legal and economic consequences. It identified and quantified the discrete bond and option elements. The implicit premise, frequently emphasised by Professor Jones and Mr Hagen under lengthy cross-examination by Alesco NZ's counsel, was that each element would be properly priced according to market considerations. At its heart would be an implicit interest charge in the lender's provision of a zero coupon bond at an issue price with a face value which required the repayment. The difference is real interest. As Professor Jones observed of Mr Schubert's developing hypothetical:

> Alesco NZ has to pay something over and above the issue price and that is a cash flow. Cash has to go out over and above what you receive. A certain amount of cash came in, more cash has to go out. That extra cash is the implicit interest cost.

[105] And as Professor Jones later explained, the zero coupon issue price would be accreted to its face value over the term because it is associated with a cash flow. Zero coupon bonds are accounted for in that way. By contrast, when a coupon bond is discounted, the liability is recognised at the issue price and then accreted as an expense until maturity to reach the face value. But the critical point is that such expenses are associated with ultimate cash flow. The only difference is that the borrower is not required to pay interest monthly; the liability accrues to maturity.

[106] At a more fundamental level, Mr Hagen explained the problem with Mr Schubert's hypothetical in this way:

> ... the accounting rules [and G22] are trying to run the transaction. Accounting is supposed to reflect what happened, not drive what happens. That seems to be the problem here. ... If [the developing hypothetical] is properly priced, then I have absolutely no argument with the treatment. ...

[107] In our judgment, Mr Schubert's hypothetical is fatally flawed by its generic comparison between two instruments providing for an advance of the same amount. It ignores the fact that, as here, their differing terms and conditions usually reflect markedly divergent legal obligations and economic consequences. A third party, as opposed to a parent-lender, would never advance an amount interest free on the terms postulated by Mr Schubert unless the borrower was paying a market cost for the funds in some other way. That burden would necessarily be reflected in the costing of either element of the hypothetical instrument; any other approach would defy economic reality. Accordingly, the cost paid by a borrower would be a genuine economic burden, properly recognisable in a claim for deductibility.

[108] Mr Schubert's hypothetical, based on a notional unbundling exercise, is of no assistance in determining whether Alesco NZ suffered a real or genuine economic cost on the OCNs.

(e) Purpose or effect of the arrangement

[109] Fifth, Mr McKay submits that, notwithstanding these findings, the purpose or effect of the OCN arrangement was not to avoid or reduce Alesco NZ's liability to tax.

[110] Mr McKay submits that Alesco NZ simply chose the OCN structure as one among a range of means when carrying out economically rational transactions. The company was seeking to promote the genuine commercial goal of funding the acquisition of two businesses. In this context it was free to structure the transactions to its best tax advantage. And the evidence shows that the taxation benefits were primarily Australian in character. That is because a deduction would have been available for Alesco NZ in New Zealand whether the company chose to fund the acquisitions by way of issuing notes or by incurring interest bearing debt.

[111] Mr McKay says that Alesco NZ's choice of the OCNs had an underlying commercial rationale. The company adopted this structure as a mechanism to fund existing financial obligations. This feature contrasts with other tax avoidance cases where the transactions would not have been entered into but for the tax benefits to be achieved.[58] Alesco NZ's acquisitions were not driven by tax considerations. The OCNs were an intermediate step along a pre-ordained commercial path.

[112] However, this distinctive factor does not protect Alesco NZ. The question is whether the particular arrangement, regardless of whether it was the originating or intermediate step, had the purpose or effect of tax avoidance. A structure whereby the parent provided funding to its subsidiary of $78 million for 10 years on an interest free basis, in exchange for the subsidiary issuing to it optional convertible notes, cannot possibly have been chosen for a predominantly commercial purpose. Mr McKay has not identified one, and nor could he.

[113] There is only one available inference: Alesco NZ adopted the OCNs solely in pursuit of the goal of tax avoidance, to obtain a taxation benefit whereby the advantage of interest deductions was totally disproportionate to the economic burden. The benefit did not naturally attach to or was not subordinate or subsidiary to an identifiable concurrent commercial purpose or effect. Nor was the benefit merely incidental to an underlying commercial purpose or effect; it was the only identifiable purpose and effect of adopting the OCN structure. We are satisfied that, but for that benefit, the OCN structure would not have been chosen.

[114] On an objective assessment, the tax avoidance purpose of this arrangement can be inferred from its effect or what it achieved. The result is a classic hallmark of tax avoidance.[59] That was necessarily the arrangement's purpose and effect. And this case is not in the rare category where a taxpayer's use of the deductibility provisions in a manner which is outside Parliamentary contemplation could nevertheless result in the arrangement's tax avoidance purpose or effect being merely incidental. The opposite is true.

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58 *Ben Nevis*, above n 3; *Penny*, above n 4; *Westpac Banking Corporation*, above n 3; and *BNZ Investments Ltd*, above n 3.

59 *Inland Revenue Commissioners v Willoughby* [1997] 1 WLR 1071 (HL), approved in *Peterson*, above n 43, at [38].

[115] We add that it is of no consequence that Alesco NZ may have been subjectively motivated in its choice of the OCNs by a taxation benefit in Australia. Mr McKay has himself criticised Heath J for adopting a subjective approach in determining the purpose or effect of an impugned arrangement. He cannot rely on the same approach to support a different finding.

[116] In any event, the Commissioner's focus is on the New Zealand anti-avoidance provisions, and any consideration of the Australian position is rendered irrelevant once an arrangement is impugned in this country. Alesco's perception that it could take advantage of a trans-Tasman taxation asymmetry may have dictated its subsidiary's decision. But that factor does not immunise Alesco NZ against the revenue consequences of its preference for one type of funding mechanism instead of another.

Conclusion

[117] In our judgment Alesco NZ has failed to discharge its burden of proving that the OCNs were not a tax avoidance arrangement and that it used the financial arrangements rules and G22 to claim deductions against its liability to income tax in a way which was within Parliament's contemplation.[60] It follows that we are satisfied that Heath J correctly dismissed Alesco NZ's challenge to the Commissioner's assessment.

Issue 2: Reconstruction

[118] Our primary finding of tax avoidance means that the OCN arrangement is, pursuant to s BG 1, void against the Commissioner for income tax purposes. Accordingly, s GB 1 applies and provides:

> **GB 1 Agreements purporting to alter incidence of tax to be void**
>
> (1) Where an arrangement is void in accordance with section BG 1, the amounts of gross income, allowable deductions and available net losses included in calculating the taxable income of any person affected by that arrangement *may be adjusted by the Commissioner in the manner the*

[60] *Ben Nevis*, above n 3, at [115].

> *Commissioner thinks appropriate*, so as to counteract any tax advantage obtained by that person from or under that arrangement, and, without limiting the generality of this subsection, *the Commissioner may have regard to*—
>
> (a) Such amounts of gross income, allowable deductions and available net losses as, in the Commissioner's opinion, that person would have, or might be expected to have, or would in all likelihood have, had if that arrangement had not been made or entered into; or
>
> (b) Such amounts of gross income and allowable deductions as, in the Commissioner's opinion, that person would have had if that person had been allowed the benefit of all amounts of gross income, or of such part of the gross income as the Commissioner considers proper, derived by any other person or persons as a result of that arrangement.
>
> (2) Where any amount of gross income or allowable deduction is included in the calculation of taxable income of any person under subsection (1), then, for the purposes of this Act, that amount will not be included in the calculation of the taxable income of any other person.
>
> (2A) Without limiting the generality of the preceding subsections, if an arrangement is void in accordance with section BG 1 because, whether wholly or partially, the arrangement directly or indirectly relieves a person from liability to pay income tax by claiming a credit of tax, the Commissioner may, in addition to any other action taken under this section—
>
> (a) disallow the credit in whole or in part; and
>
> (b) allow in whole or in part the benefit of the credit of tax for any other taxpayer.
>
> (Our emphasis.)

[119] The Commissioner's discretion is broad. She may adjust all relevant elements of the OCN transactions as she "thinks appropriate" for the purpose of counteracting Alesco NZ's tax advantage. In taking that step the Commissioner may in her discretion refer to a hypothetical alternative transaction, with all the associated elements of gross income, allowable deductions and available net losses, which the Commissioner considers the taxpayer was likely to have used if the impugned transaction had not been entered into.

[120] Once she voided the OCN transactions, the Commissioner's adjustment function was relatively straightforward. The obvious means of counteracting Alesco NZ's tax advantage obtained from claiming deductions for interest payments

under a voided arrangement was to disallow them. This step had the effect, as Mr Brown observes, of curing the impermissible tax advantage and reversing any tax loss offset which Alesco NZ made to other members of its group.[61]

[121] Nevertheless, Mr McKay submits that the Commissioner erred because she failed to positively reconstruct by reference to an identified or identifiable alternative funding arrangement according to Alesco NZ's counterfactual reconstruction. He accepts that the Commissioner is entitled to compare the position existing before the arrangement and the deductions it provides with the enhanced deductions arising from the arrangement.

[122] But Mr McKay poses the rhetorical question: how is the tax advantage to be determined, and by reference or comparison to what transaction, where the funding entered into is for a new acquisition? He relies upon Lord Hoffmann's observation in *Miller*[62] that the Commissioner's duty is to make an assessment by reference to what in her opinion was likely to have had happened if there had been no scheme. He postulates as the appropriate counterfactual Alesco NZ's likely funding by an interest bearing loan from Alesco.

[123] Mr McKay's argument fails for two reasons which we can articulate briefly. First, his submission is wrong in law. The terms of s GB 1 are plain. In exercising her discretion the Commissioner "may have regard to" an alternative funding arrangement. But she is not bound to take that step, and nor should she be where the tax advantage can be counteracted simply by disallowing the impermissible deductions. It is immaterial that Alesco NZ required the funding for a new acquisition. That is because the appropriate comparison was available within the available taxation treatments of the OCNs: that was precisely how she adjusted Alesco NZ's liability.

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61 *Ben Nevis*, above n 3, at [170]; TAA, s 149A(2)(b).

62 *Miller*, above n 22, at [3].

[124] As this Court noted in *Miller*, in exercising her discretion the Commissioner is entitled to confine herself solely to negating the benefit enjoyed by Alesco NZ.[63] Or, as this Court said in *Accent Management*:[64]

> … the counter-factual envisaged by s GB 1(a) is the position "if that arrangement had not been made or entered into". There is thus no need for the Commissioner (or Court) to conjure up an alternative and more effective scheme into which the tax payers might have entered.

[125] Mr McKay has cited Lord Hoffmann's observation in *Miller* out of context. In *Miller* the Commissioner first exercised his powers in the same way as this case by disallowing the impermissible deductions claimed under an impugned transaction. However, the taxpayer frustrated that adjustment. So the Commissioner then reconstructed the transaction by "having regard to" what the taxpayer would have done if he had not implemented the tax avoidance scheme.

[126] In *Miller* Lord Hoffmann did no more than affirm the Commissioner's statutory power to have regard to an alternative or counterfactual in circumstances where the taxpayer challenged it on appeal. But he certainly did not say, as Mr McKay suggests, that the Commissioner is under an affirmative duty to adjust by having regard to the tax effect of what is said to be the most likely counterfactual transaction.

[127] Second, even if Mr McKay was correct in law, if the Commissioner had reconstructed by reference to another transaction she was not obliged to adopt an interest bearing loan hypothetical as the likely alternative. We have already rejected this argument when addressing Mr McKay's submission that Alesco NZ's adoption of the OCN structure did not enable it to avoid or reduce its liability to tax.[65] Mr McKay nevertheless runs the same argument in the reconstruction context. He says the consequence of the Commissioner's refusal to reconstruct according to a hypothetical is to completely deny Alesco NZ any interest deductions when funding the two acquisitions. That consequence is, he says, excessive and wrong.

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63 *Miller v Commissioner of Inland Revenue* [1999] 1 NZLR 275 (CA) at 302.
64 *Accent Management*, above n 16, at [155]; *Westpac Banking Corporation*, above n 3, at [623].
65 At [33]–[51] above.

[128] We agree with Mr Brown. A reconstruction based upon adoption of Mr McKay's hypothetical would have two unacceptable consequences. One would be a failure to counteract the tax advantage obtained by Alesco NZ's use of the OCNs. The other would be to allow the company to secure an increased tax advantage in the form of greater deductions and allocation of more tax losses to its subsidiaries.[66] That result would, as Mr Brown observes, be perverse, enabling Alesco NZ to benefit from the consequences of its own unlawful conduct. Heath J was correct to accept this proposition.[67]

[129] Alesco NZ's appeal against the Commissioner's exercise of her adjustment powers under s GB 1 following voidance of the OCN arrangement is dismissed.

Issue 3: Shortfall penalties

[130] The Commissioner is empowered to impose a shortfall penalty on a taxpayer where there is a tax shortfall. That shortfall is measured by the difference between the tax effects of the taxpayer's position and the correct position.[68] Relevantly, the Commissioner is entitled to impose a shortfall penalty on a taxpayer who takes an unacceptable tax position[69] or an abusive tax position.[70] However, a finding of the former is a prerequisite to the latter.

[131] The Commissioner was satisfied that Alesco NZ's tax position on the OCNs was both unacceptable and abusive. She imposed shortfall penalties for the interest deductions claimed by Alesco NZ between the years 2003 and 2008. She was entitled to impose a penalty equal to 100 per cent of the tax deductions. However, she reduced that penalty to 50 per cent to take into account Alesco NZ's prior history of good tax compliance.[71]

[132] Alesco NZ challenged the Commissioner's imposition of shortfall penalties. Heath J dismissed this challenge; he was satisfied that the Commissioner did not err

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66 *Accent Management*, above n 16, at [152]–[155].
67 At [159].
68 TAA, s 3(1).
69 TAA, s 141B.
70 TAA, s 141D.
71 TAA, s 141FB.

in law in imposing the penalties.[72] On appeal, Mr McKay submits that Heath J erred. He says that, because the criteria for determining an unacceptable tax position were not satisfied, the Commissioner had no power to impose an abusive tax position shortfall penalty.

[133] Before considering Mr McKay's argument, we record that an unacceptable tax position is defined as:

> **141B Unacceptable tax position**
>
> (1) 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.
>
> …
>
> (5) For the purposes of this section, the question whether any tax position is acceptable or unacceptable shall be determined as at the time at which the taxpayer takes the taxpayer's tax position.
>
> ...
>
> (7) The matters that must be considered in determining whether the taxpayer has taken an unacceptable tax position include—
>
> (a) The actual or potential application to the tax position of all the tax laws that are relevant (including specific or general anti-avoidance provisions); and
>
> (b) Decisions of a court or a Taxation Review Authority on the interpretation of tax laws that are relevant (unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position).
>
> ...

[134] An abusive tax position is defined as:

> **141D Abusive tax position**
>
> (1) The purpose of this section is to penalise those taxpayers who, having taken an unacceptable tax position, have entered into or acted in respect of arrangements or interpreted or applied tax laws with a dominant purpose of taking, or of supporting the taking of, tax positions that reduce or remove tax liabilities or give tax benefits.
>
> (2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an abusive tax position (referred to as an **abusive tax position**).

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[72] At [180].

(3) The penalty payable for taking an abusive tax position is 100% of the resulting tax shortfall.

...

(4) This section applies to a taxpayer if the taxpayer has taken an unacceptable tax position.

(5) Section 141B(6) applies for determining the time when a taxpayer takes an abusive tax position.

(6) A taxpayer's tax position may be an abusive tax position if the tax position is an incorrect tax position under, or as a result of, either or both of—

(a) a general tax law; or

(b) a specific or general anti-avoidance tax law.

(7) For the purposes of this Part …, an **abusive tax position** means a tax position that,—

(a) is an unacceptable tax position at the time at which the tax position is taken; and

(b) viewed objectively, the taxpayer takes—

(i) in respect, or as a consequence, of an arrangement that is entered into with a dominant purpose of avoiding tax, whether directly or indirectly; or

(ii) where the tax position does not relate to an arrangement described in subparagraph (i), with a dominant purpose of avoiding tax, whether directly or indirectly.

[135] Heath J referred extensively to authority but we are content to rely on the statutory tests which clearly identify the essential elements and the approach mandated by *Ben Nevis*.[73]

[136] Mr McKay advances a number of grounds in support of his argument that Alesco NZ did not take an unacceptable tax position. First, he submits that the company's position on the OCNs satisfied the standard "of being about as likely as not to be correct". By reference to s 141B(7)(b), he submits that the Court is bound to consider relevant decisions on the interpretation of deductibility and anti-avoidance provisions which had been issued by February 2003.

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[73] *Ben Nevis*, above n 3, at [177]–[180] and [188].

[137] Mr McKay says that when Alesco NZ adopted the arrangement[74] it considered *Auckland Harbour Board*[75] to be the closest analogous contemporary decision on s BG 1, and in particular its authority for the principles that: (a) the intention and effect of legislation is best obtained by referring to the words used by Parliament; and (b) the general anti-avoidance provision should not be invoked as a statutory backstop because that would amount to imposing tax by administrative discretion instead of by law.

[138] However, it is irrelevant that when implementing the OCN structure Alesco NZ may have considered *Auckland Harbour Board* to be the most recent analogous authority; that is because the test is objective. Moreover, we agree with Mr Palmer that *Auckland Harbour Board* does not assist Alesco NZ. In that case the taxpayer claimed a deduction for a loss in accordance with a negative base price adjustment following disposal of Government stock to a related entity without financial consideration. The Commissioner accepted that the accruals rules, strictly construed, allowed the taxpayer to claim a deduction. But he invoked the relevant statutory anti-avoidance provisions on the ground that the intent and purpose of the rules was to defeat the accrual rules.

[139] In *Auckland Harbour Board* the Privy Council agreed with the taxpayer, applying ordinary principles of statutory construction to the rules themselves. Significantly, however, Lord Hoffmann observed that a difference between the commercial reality of the transaction and its juristic nature for the purpose of obtaining the relevant tax benefit would have justified invoking the anti-avoidance provisions. In *Auckland Harbour Board,* in contrast to this case, there was no conflict of that nature; the subject disposition was in legal, commercial and all other terms a transfer of financial arrangements for no consideration. Lord Hoffmann's

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74 Whether a taxpayer's interpretation of a tax law is unacceptable must be determined at the time the taxpayer takes the position by filing a return: ss 141B(5) and (6) of the TAA and *Ben Nevis*, above n 3. Before us counsel did not identify a particular date when the first return was filed but, like Heath J in the High Court, treated Alesco NZ's tax returns for the 2003 year as the appropriate touchstone. We shall proceed accordingly.

75 *Auckland Harbour Board*, above n 38.

reference to the anti-avoidance provision as a "long stop"[76] does not detract from this analysis.[77]

[140] By 2003 the principles relating to construction of the anti-avoidance provisions had been settled by the Privy Council's decision in *Challenge*,[78] affirming Woodhouse J's dissent in this Court. While in *Ben Nevis* the Supreme Court expanded upon and restated the *Challenge* provisions, its approval of both relevant judgments is unequivocal.[79] And, after surveying all the leading authorities on the application of the anti-avoidance provisions to cases of what it called "contrived deductions",[80] the Court concluded that the principles we have applied were settled by 1998.

[141] We are satisfied that, for the reasons given, we would have reached the same conclusion on the OCNs, for largely the same reasons, by applying the statutory anti-avoidance provisions in 2003 as we have in this case. Despite Mr McKay's comprehensive submissions in support of the appeal, we are satisfied that Alesco NZ's position has always been unarguable.

[142] Second, Mr McKay submits that Alesco NZ entered into the OCNs arrangement after receipt of reputable and expert taxation advice. Other taxpayers had done the same, adopting a similar template. It must be assumed, he says, that the advice received by Alesco NZ was positive in concluding that s BG 1 did not apply.

[143] Again, this argument postulates a subjective inquiry and is irrelevant. Alesco NZ's acceptance of professional advice does not immunise it from a statutory liability for shortfall penalties. The fact that it was positive does not mean it was correct.[81] Moreover, as Mr Palmer points out, KPMG expressly advised in its opinion dated 27 February 2003 that adoption of the arrangement would result in

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76 *Auckland Harbour Board*, above n 38, at [11].
77 *Ben Nevis*, above n 3, at [100].
78 *Challenge*, above n 17.
79 *Ben Nevis*, above n 3, at [94]–[96].
80 *Ben Nevis*, above n 3, at [197].
81 *Ben Nevis*, above n 3, at [183]–[203].

interest deductions for income tax purposes even though in a commercial sense no interest was actually paid.

[144] Third, Mr McKay relies on Alesco NZ's understanding that it was bound on KPMG's advice to recognise for financial reporting purposes an expense on the OCNs. The short answer is that Alesco NZ knew or must have known, as Mr McKay himself acknowledges, that the accounting treatment of a transaction does not dictate its taxation treatment.

[145] Fourth, Mr McKay relies on the Commissioner's decision on 26 September 2006 to issue Determination G22A (G22A). That instrument used explicit and unambiguous terms to exclude the operation of the debt and equity separation methodology contained in G22 when applied to OCNs issued between wholly owned group members. The fact that the Commissioner thought it necessary to clarify the position through a new determination suggests that applying G22's methodology to related party issues was at the very least reasonably arguable.

[146] Again our answer can be expressed shortly. While we can infer that the Commissioner acted for remedial or clarification purposes in issuing G22A, that step does not imply that the situation prevailing before 26 September 2006 would have allowed a taxpayer to lawfully claim expense deductions for notional interest payments. The Commissioner's decision is equally open to construction as a direct message to those taxpayers like Alesco NZ which adopted the HINZ template that there was no room for argument on the issue.[82]

[147] Fifth, Mr McKay submits, even if the threshold test of an unacceptable tax position is satisfied, Alesco NZ did not take an abusive tax position because there is no evidence that, viewed objectively, the company entered into the OCNs with the dominant purpose of avoiding tax, whether directly or indirectly. He repeats his earlier submission that Alesco NZ did not act with that purpose given that it adopted the OCNs to pursue its economically rational objective of funding a genuine commercial transaction; and it was not a situation where the taxation advantages came first and the transaction followed. He says Alesco NZ's only fault was to

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[82] *Databank v Commissioner of Inland Revenue* [1990] 3 NZLR 385 (PC) at 394.

choose the OCNs in circumstances where they provided only 50 per cent of the deductions which would have been available if the company had employed an alternative funding arrangement such as interest bearing debt.

[148] As Mr McKay accepts, *Ben Nevis* confirms that when considering this issue the Court is required to view the arrangement objectively by reference to its features rather than Alesco NZ's intentions in taking the tax position linked to the arrangement.[83] As in the tax avoidance inquiry, the focus is on the purpose of the arrangement itself. *Ben Nevis* also confirms that a finding of tax avoidance does not necessarily lead to a conclusion that the tax position was not more likely than not to be correct when it was taken.[84] The inquiry is not to be influenced by a later finding that the tax position taken was incorrect.

[149] We have already concluded that, first, the OCNs were a tax avoidance arrangement, and in particular that there was no purpose for Alesco to advance $78 million to Alesco NZ interest free for 10 years under convertible notes except to secure a tax advantage by claiming expense deductions for notional interest payments; and, second, the same finding would have been made by applying the law as it stood in 2003. Accordingly, we are satisfied that Alesco NZ entered into the transactions for the dominant purpose of avoiding tax and took an abusive tax position within the meaning of s 141D. The more Alesco NZ's case is examined, the more it reinforces our conclusion.

[150] Alesco NZ's appeal against the Commissioner's imposition of shortfall penalties is dismissed.

Result

[151] Alesco NZ's appeal is dismissed.

[152] Alesco NZ must pay costs to the Commissioner for a complex appeal on a band B basis and usual disbursements. We certify for two counsel.

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83 *Ben Nevis*, above n 3, at [204]–[209].
84 *Ben Nevis*, above n 3, at [184]–[185].

Solicitors:
Bell Gully, Auckland for Appellants
Crown Law Office, Wellington for Respondent