**IN THE HIGH COURT OF NEW ZEALAND**
**AUCKLAND REGISTRY**

**CIV 2009-404-2145**
**CIV 2009-404-4528**
**CIV 2010-404-4693**
**CIV 2011-404-4025**

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|---|---|
| UNDER | the Tax Administration Act 1994 |
| IN THE MATTER OF | the Income Tax Act 1994 |
| BETWEEN | ALESCO NEW ZEALAND LTD AND ORS<br>Plaintiffs |
| AND | COMMISSIONER OF INLAND REVENUE<br>Defendant |

Hearing: 12, 13, 14, 15, 16, 19, 20, 21, 22, 23, 26, 27, 28, 29 September 2011

Counsel: L McKay, R G Simpson and M McKay for Alesco NZ Ltd
B W F Brown QC, M S R Palmer, J H Coleman and R L Roff for Commissioner of Inland Revenue

Judgment: 12 December 2011

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**JUDGMENT (NO. 2) OF HEATH J**

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*This judgment was delivered by me on 12 December 2011 at 11.30am pursuant to Rule 11.5 of the High Court Rules*

*Registrar/Deputy Registrar*

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## The proceedings

[1] Alesco New Zealand Ltd (Alesco NZ) and other subsidiary companies[1] challenge decisions of the Commissioner of Inland Revenue (the Commissioner) to declare an arrangement void, under the general anti-avoidance provisions of the income tax legislation. If that were unsuccessful, they also dispute the

[1] These are Parbury Building Products (NZ) Ltd (as successor to Robinhood Ltd), Alesco NZ Trustee Ltd, Thermo Fisher Scientific New Zealand Ltd (previously Biolab Ltd) and Concrete Plus Ltd.

Commissioner's re-calculation of assessable income and his decision to impose shortfall penalties.

[2] There are four proceedings:

(a) In CIV 2009-404-2145, Alesco NZ challenges the Commissioner's decisions to disallow interest deductions totalling $5,687,729, for the 2003, 2004 and 2005 tax years.

(b) In CIV 2009-404-4528, Parbury Building Products (NZ) Ltd, Biolab Ltd, Robinhood Ltd and Alesco NZ Trustee Ltd[2] challenge the Commissioner's decisions to reduce loss offsets from Alesco NZ totalling $1,910,846, for the 2003, 2004 and 2005 tax years.

(c) In CIV 2010-404-4693:

   (i) Alesco NZ challenges the Commissioner's decisions to disallow interest deductions totalling $9,277,629, for the 2006, 2007 and 2008 tax years, and

   (ii) Parbury Building Products (NZ) Ltd, Thermo Fisher Scientific New Zealand Ltd and Concrete Plus Ltd challenge the Commissioner's decisions to reduce loss offsets from Alesco NZ, totalling $4,537,757, for the 2006 and 2007 tax years.

(d) In CIV 2011-404-4025, Alesco NZ challenges the assessment of shortfall penalties totalling $2,469,282, for the 2003, 2004, 2005, 2006, 2007 and 2008 tax years.

[3] Alesco NZ is a wholly owned subsidiary of Alesco Corporation Ltd (Alesco Corporation), a company listed on the Australian Stock Exchange. At issue are amortised interest deductions claimed by Alesco NZ arising out of the use of optional convertible notes (the Notes), in intra-group arrangements, to finance the

[2] Biolab Ltd has been renamed Thermo Fisher Scientific New Zealand and Robinhood Ltd was amalgamated with Parbury Building Products (NZ) Ltd: see para [2](c) below.

acquisition of two businesses operated by New Zealand based companies. At the direction of Alesco Corporation, those businesses were purchased through Alesco NZ.[3] The money required to fund the acquisitions came directly from Alesco Corporation.

[4] For the relevant income years, the interest deductions and loss offset elections made by Alesco NZ and its subsidiaries resulted in a reduction of income tax otherwise payable by New Zealand members of the Alesco Group. As a consequence of treating the financial instruments as void, the Commissioner has disallowed claimed interest deductions for the 2003–2008 years and has reversed loss offset elections for the 2003–2007 income years.

[5] Only the 2003-2008 income years are presently in issue. The Commissioner has determined that Alesco NZ's revised assessable income tax for those years is $4,938,568. Shortfall penalties have been levied, in the sum of $2,469,009. Use of money interest has accumulated; at the end of the hearing, I was told that a sum of approximately $1.2 million was owing. The total amount in dispute in these proceedings is something in the order of $8.6 million.

[6] Similar financing structures[4] have been used in other cases. Alesco NZ is one of 16 taxpayers who have challenged decisions made by the Commissioner to treat this form of financing structure as tax avoidance. The aggregate total of core tax and penalties at stake in all of the proceedings, for the 2003–2008 tax years, is approximately $226 million, plus accruing use of money interest. The Commissioner believes that the amount of revenue in dispute is over $300 million. While this is not a designated test case,[5] in a practical sense my decision is likely to influence the course of the remaining proceedings.

**An overview**

[7] In 2002, Alesco Corporation was contemplating the acquisition of industrial businesses in New Zealand. Two targets were identified. One, Biolab Ltd (Biolab),

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[3] See paras [8] and [9] below.
[4] See paras [16]–[26] below.
[5] Tax Administration Act 1994, s 138Q.

was primarily involved in the distribution of medical laboratory equipment. The other, Robinson Industries Ltd (Robinson), produced and distributed laundry tubs, kitchen air extractor systems and rangehoods. Alesco Corporation made a commercial decision to acquire the two businesses. Having done so, it was necessary to determine the entity that would effect the purchases and the way in which the transactions could be financed.

[8] Alesco Corporation nominated Alesco NZ to purchase 100% of the shares in Biolab. The purchase price was $46 million. Of that sum, $6,040,280 was satisfied by Alesco Corporation assuming a debt owed by Biolab (Aust) Pty Ltd (Biolab Australia). Later, a contractually agreed "earn-out" payment of $9,191,000 became payable, making the total purchase price $55,191,000.

[9] The major shareholder in Robinson declined to give the warranties sought by Alesco Corporation, in relation to the sale of shares. As a result, Alesco Corporation arranged for Alesco NZ to acquire the Robinson business. That was done through Alesco NZ's wholly owned subsidiary, Robinhood Ltd (Robinhood). The purchase price was $28,653,345, payable as to $27,850,000 on settlement on 30 April 2003 and an "earn-out" payment of $1 million in August 2004.

[10] There was nothing artificial about the acquisitions or the way in which Alesco Corporation raised money to finance them. Real businesses were acquired with real money. Alesco Corporation raised something in the order of $85 million through debt and equity financing, to enable the transactions to be completed.

[11] The Commissioner's tax avoidance concerns are focussed squarely on the intermediate arrangements that were put in place, by which Alesco Corporation made the inter-company advances to Alesco NZ to enable the purchases to be settled in New Zealand.

[12] Understandably, to lessen its transaction costs, Alesco Corporation was keen to ensure that the inter-company financing arrangements were structured in the most tax-effective way. Advice was taken from its business and tax advisers, KPMG, in

both Australia and New Zealand.[6] Following receipt of that advice, Alesco Corporation decided to use a form of optional convertible note to record payments totalling $78 million to Alesco NZ.

[13] The Notes[7] were issued by Alesco NZ, in favour of Alesco Corporation. The sum of $78 million was paid to Alesco NZ in three tranches, each pursuant to a separate Note. The purchase price for the shares in Biolab was funded in two segments, one in March 2003 and one in September 2003, reflecting the two stages of payment of approximately $41 million and $9 million respectively. Another advance, in April 2003, was made to acquire the Robinson assets.

[14] Each of the Notes contained debt and equity components. KPMG advised Alesco Corporation that this type of financial instrument would allow Alesco NZ to claim interest deductions in New Zealand.

**The choice of inter-company financing structure**

[15] At material times during 2003, Mr Alan Fonseca was Alesco Corporation's Group Financial Controller. From then until July 2008, he was its Chief Financial Officer. Mr Fonseca gave evidence about the basis on which the Alesco Corporation board decided to structure the internal funding arrangements.

[16] In 2002 and 2003, Mr Fonseca had responsibility for the Alesco Group's funding management and banking/borrowing arrangements. He was responsible for reporting to Alesco Corporation's board and recommending the most tax-effective method by which the Biolab and Robinson acquisitions could be funded.

[17] Mr Fonseca had direct dealings with KPMG Australia. In a discussion document entitled "Financing Opportunities Australia and New Zealand", dated 21 January 2003, KPMG suggested the use of "hybrid equity". This term was used to describe a funding instrument containing elements of debt and equity. KPMG recommended a product that it had devised, known as "Hybrid Into New Zealand"

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[6] See paras [16]–[34] below.
[7] The relevant terms of the Notes are set out at paras [56]–[61] below.

(HINZ). KPMG marketed this scheme on the basis that it had previously been used by a number of "Top 100 Australian listed companies" that had invested in New Zealand enterprises. On one occasion, it informed Alesco Corporation that many of those companies had "conservative boards".

[18] On 22 January 2003, KPMG Australia wrote to Mr Harrison, the Finance Director at Alesco Corporation, confirming the terms of its engagement "to implement a hybrid financial instrument for Alesco Corporation ... in relation to [Alesco Corporation's] financing requirements" for the purpose of proposed acquisitions in New Zealand. As part of that engagement, KPMG was to provide advice on Australian and New Zealand accounting treatment, income tax and goods and services tax.

[19] Alesco Corporation's directors met on 28 January 2003. The board received a report titled "Project Bledisloe and Project Pete Board Update". That report, from Mr Harrison, touched on the inter-company funding arrangement. He reported:

> 4. Potential financing mechanism – KPMG have bought [sic] to our attention a tax-effective financing mechanism for the acquisition. Essentially, *the hybrid structure of the financing produces a deduction for deemed or notional interest expense in New Zealand but does not give rise to either New Zealand withholding tax or assessable income in Australia*. Subject to further review of the opportunity and an acceptable proposal from KPMG, I would like to pursue the opportunity. (my emphasis)

[20] On 28 January 2003, Alesco Corporation Ltd signed an agreement, as purchaser, to acquire all the shares in Biolab Ltd. At this time, no final decisions had been made on the structure to be used for the inter-company advances. On 29 January 2003, Alesco Corporation announced to the Australian Stock Exchange that it had entered into the Biolab acquisition agreement, which was conditional upon compliance with regulatory requirements in New Zealand and obtaining acknowledgements from Biolab's suppliers that they would continue to supply to that company.

[21] On 31 January 2003, Mr Fonseca emailed Mr Harrex (of KPMG) requesting "a formal kick off meeting regarding the hybrid structure". Mr Fonseca also asked for a copy of "Determination G22: Optional Conversion Convertible Notes

Denominated in New Zealand Dollars Convertible at the Option of the Holder" (G22).

[22] Some of the documents generated by KPMG during the development phase of the inter-company funding arrangements contain a word processing footer that linked the specific Alesco documents to the generic "HINZ" product. An example is the attachment to an email forwarded by Mr Harrex to Mr Fonseca and Mr Harrison, which contains an engagement letter from KPMG Australia dated 22 January 2003 and identifies New Zealand tax benefits of between $3.4 million and $5.7 million from what was then a notional funding plan. Those benefits were to be derived from "interest" deductions generated through use of the generic hybrid instrument.

[23] On 5 February 2003, KPMG Australia reported further on the acquisition and funding structures for the acquisition of Biolab. The advice was focussed on tax implications, both from Australian and New Zealand perspectives. In discussing the funding structure, KPMG appended diagrams indicating the way in which the hybrid arrangement would operate. Advice was given that Alesco Corporation's external loans should be deductible, subject to compliance with the Australian "thin capitalisation rules". As a consequence of the acquisition, taxable profits in New Zealand were expected to increase. KPMG regarded the interest claimable in New Zealand and the ability to offset group losses as likely to reduce the Alesco group's taxable profits overall.

[24] After receiving further advice, Mr Fonseca reported to Alesco Corporation's board of directors on 17 February 2003. Dealing with the Biolab acquisition, Mr Fonseca's memorandum began by stating:

> In relation to financing the Biolab acquisition in the most tax effective manner, the KPMG structured finance division have suggested the use of a hybrid instrument in the form of a convertible note.

[25] Reflecting correspondence that had passed between KPMG Australia and Alesco Corporation, as well as discussions among those responsible for managing the process, Mr Fonseca went on to explain the nature of the convertible note. Relevantly, for present purposes, he wrote:

**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.*

(my emphasis)

[26] While Mr Fonseca mentioned Australian tax advantages to Alesco Corporation (interest received from Alesco NZ was not assessable but interest paid on debt incurred by Alesco Corporation was deductible),[8] the main thrust of his memorandum was directed to the accounting and taxation treatment of the Note in New Zealand. Three New Zealand tax advantages were identified:

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[8] See also Mr Harrison's report for the board meeting on 28 January 2003, set out at para [19] above.

(a) The ability for Alesco NZ to claim interest as a deduction on its assessable income in New Zealand.

(b) The ability for Alesco NZ (a non-trading company) to transfer a tax loss equal to the notional interest deduction for the particular income year to other wholly owned Alesco companies in New Zealand, thereby minimising the group's income tax obligations in New Zealand.

(c) The absence of liability for New Zealand non-resident withholding tax.

[27] At their meeting on 18 February 2003, the directors of Alesco Corporation resolved:

> **Biolab Financing Mechanism**
>
> Mr Fonseca tabled a memorandum to the Board outlining the nature of the proposed financing structure. Providing the relevant sign offs from KPMG audit and tax were received **it was resolved** to proceed with the use of convertible notes to finance the Biolab acquisition.

[28] As a result of further interaction between Mr Fonseca and KPMG personnel, KPMG Australia wrote to Mr Fonseca on 26 February 2003, about the Australian taxation implications of the proposed transaction. On 27 February 2003, KPMG NZ provided separate advice on the New Zealand tax situation to Mr Harrison.

[29] In the letter dealing with Australian tax consequences, KPMG Australia wrote:

> ***Interest deductibility***
>
> Interest incurred by Alesco Corporation Limited relating to subscribing for the Convertible Notes should be deductible to Alesco Corporation Limited, as the use to which the borrowed funds are put will greatly enhance the profitability of Alesco New Zealand Limited, and its ability to generate income to Alesco Corporation Limited in the form of dividends on the ordinary shares held by Alesco Corporation Limited. ...
>
> ...

***General anti-avoidance***

The general anti-avoidance provisions contained within Part IVA [of the Australian tax legislation] should not apply to the refinancing of the Australian and New Zealand operations because in our opinion it is not reasonable to predicate a tax benefit that would have been derived, and also because the transaction was not entered into for the dominant purpose of obtaining any tax benefit.

[30] KPMG Australia considered the possible effect of the Australian general anti-avoidance provisions in more detail. They said:

*Scheme*

The issue of the Convertible Notes by Alesco New Zealand Limited, on the terms outlined in this opinion, including the feature that the notes do not bear interest, and together with the initial debt financing thereof, could potentially constitute a "scheme".

*No tax benefit*

A "tax benefit" includes either an amount not being included in the taxpayer's assessable income, where that amount might reasonably be expected to have been included if the scheme had not been entered into or carried out; and also a deduction being allowable to a taxpayer that might reasonably be expected not to have been allowable if the scheme had not been entered into or carried out. This involves a predication as to what might have occurred but for the scheme. In our opinion, it is not reasonable to predicate either that:

- Alesco New Zealand Limited would have borrowed directly from New Zealand banks instead of Alesco Corporation Limited borrowing from Australian banks and injecting equity into Alesco New Zealand Limited. This is because based simply on its pre-existing balance sheet and without parent company credit support Alesco New Zealand Limited would not have been able to cost effectively fund the acquisition by debt; or

- Alesco Corporation would have borrowed and on lent NZD 38 million by way of interest bearing debt (convertible or otherwise) to Alesco New Zealand Limited, and thus derived an NZD income stream for a fixed term in excess of ten years. Primarily, this is because commercially it would be exceptionally unusual for an Australian parent to arrange the long term funding requirements of its foreign subsidiaries in such a manner.

*Dominant non-tax purposes*

*The scheme forms part of an overall commercial acquisition, and entails substantial foreign [New Zealand] tax benefits, compared to the funding by way of a direct equity investment. These factors strongly point towards non-Australian tax purposes. The scheme directly results in an improvement in the Australian consolidated financial reporting result due to the lower*

> *consolidated foreign income tax expense.* Accordingly, *this factor also strongly points away from a dominant purpose of obtaining an Australian tax benefit.* (my emphasis)

[31] It is common ground that the Alesco group was seeking to secure the most tax-effective means of financing the acquisitions. The highlighted extract from KPMG Australia's advice makes it clear that the dominant purpose of the arrangement was not to secure an Australian tax benefit. As the purpose was to secure the most tax-effective funding structure, the natural inference is that the dominant purpose of the arrangement was to obtain a New Zealand tax advantage.

[32] KPMG NZ's letter of 27 February 2003 addressed the anti-avoidance provisions of the New Zealand income tax legislation. A more detailed discussion on "anti-avoidance risk" was incorporated into an attached discussion paper.[9] The discussion paper concluded:

> *Application of section BG 1 to Convertible Notes Funding*
>
> In assessing the risk of section BG 1 [of the Income Tax Act 1994] being successfully applied it is necessary to examine in some detail the underlying scheme and purpose of the relevant legislation in the context of the proposed financing transaction.
>
> The resulting tax outcome of Alesco NZ issuing interest free Convertible Notes (ie a deemed interest deduction) to meet future financial commitments arises by virtue of the requirement to follow Determination G22. *Determination G22 specifically provides for a deemed interest deduction being allowed in the case of certain interest free Convertible Notes. Therefore, plainly and simply, the tax outcomes of the proposed financing transaction is clearly within the scheme and purpose of the Act.*
>
> Further, Determination G22 contemplates that interest may (or may not) be payable under a Convertible Note. Therefore, the deemed interest deduction that arises under Determination G22 could not be said to be unintended.
>
> Finally, financing via Convertible Notes rather than conventional debt will result in more, and not less, tax being paid in New Zealand as the deemed interest deduction under Determination G22 is in fact less than the

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[9] This discussion paper preceded the contemporaneous decisions of the Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 and *Glenharrow Holdings Ltd v Commissioner of Inland Revenue* [2008] NZSC 116, [2009] 2 NZLR 359. Among other authorities, reference is made in the discussion document to *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 (PC), *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] AC 450 (PC), *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (PC) and *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (PC).

> deductions that would be incurred if conventional debt funding was used and a commercial interest rate was charged.
>
> *2.5.3 Specific Anti-avoidance*
>
> Section GD 11 of the Income Tax Act contains a specific anti-avoidance provision concerning the accrual rules. This section provides that, where the Commissioner of Inland Revenue is satisfied that the parties to a financial arrangement deal with each other in a way that defeats the intention of the accrual rules, the Commissioner may deem the consideration relating to the financial arrangement to be that which independent parties dealing at arm's length would give.
>
> *Consistent with our comments above, we do not consider this anti-avoidance provision can apply in the present situation. This is because Alesco NZ is merely applying (as it is required to do by law) the principles espoused in Determination G22 as part of the calculation of its annual tax liability. Furthermore, the Convertible Note is not being entered into by Alesco NZ with the intention of defeating the accrual rules; it is being entered into to acquire an investment in New Zealand.*
>
> ... (my emphasis)

[33] On 27 February 2003, KPMG Australia provided accounting advice to Mr Fonseca, in relation to the financing of the Biolab acquisition. KPMG advised Alesco Corporation to "bifurcate the Convertible Notes into a debt receivable and an equity investment in controlled entity ... because the accounting treatment in Alesco Corporation Limited should be consistent with that mandated for Alesco NZ Limited". The first tranche of Notes (for the Biolab purchase) was issued by Alesco NZ to Alesco Corporation on 3 March 2003, pursuant to appropriate board resolutions, and a "subscription agreement for Convertible Notes".

[34] On 1 April 2003, Alesco Corporation's board received a report on the proposed acquisition of the Robinson business, entitled "Project Marian Board Update". The board was told that Alesco Corporation expected to be able to "partially fund the deal with a convertible note issue from Alesco NZ to Alesco Corporation, *generating a tax advantage in New Zealand*" (my emphasis). The report made it clear that the extent to which that funding structure could be used would "depend upon the final deal structure and advice from KPMG". On 14 April 2003, a second tranche of Notes was issued by Alesco NZ, to fund Robinhood's acquisition of the Robinson business. Later, on 1 September 2003, a third tranche

was issued, to provide funds to meet the "earn-out" payment on the Biolab acquisition.

[35] In his written evidence in chief, Mr Fonseca compared the Australian tax treatment of the Notes with that applicable in New Zealand:

> 63. The taxation treatment in Australia is not symmetrical to the position for financial reporting and New Zealand tax purposes. In Australia a 10-year [optional convertible note] 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 [optional convertible notes] in Australia and New Zealand.

[36] While Mr Fonseca's evidence was that taxation advantages in Australia drove the Note structure (as opposed to those available in New Zealand), that view is inconsistent with the contemporary documentation and is not objectively sustainable. KPMG Australia's correspondence and the internal Alesco Corporation memoranda highlight the emphasis placed on New Zealand tax advantages and the reasons why the Australian anti-avoidance provisions were unlikely to be engaged.[10]

[37] To the extent that dual taxation considerations may have been involved, I am satisfied that Alesco Corporation's primary objective in accepting KPMG's advice about the inter-company financing structure was to obtain tax advantages in New Zealand. Any other view would be inconsistent with the use of a template scheme that was designed expressly to provide benefits to Australian companies investing in New Zealand.

**Competing contentions**

[38] Although Alesco NZ bears the onus of proving that the arrangement was not tax avoidance,[11] it is easier to understand the positions taken by each party if the Commissioner's contentions are summarised first.

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[10] See paras [19], [21], [23]–[27], [29]–[32] and [34] above. See, in particular, the highlighted portions of the extracts set out at paras [30] and [34].

[11] Tax Administration Act 1994, s 149A(2)(b) and *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [156].

[39] In reliance on three recent judgments of the Supreme Court,[12] the Commissioner submits that the general anti-avoidance provisions contained in s BG 1 of the Income Tax Act 1994 (the Act) are engaged.[13] The Commissioner contends that the HINZ optional convertible note was a "structured financial product" that Alesco Corporation bought from KPMG for the purpose of allowing Alesco NZ to obtain impermissible tax benefits in New Zealand. The Commissioner focuses on use of the three Notes to establish a "tax avoidance arrangement".

[40] Mr Brown QC, for the Commissioner, observed that the product was not selected from a "suite of alternative financing structures" and pointed to the absence of any negotiation between Alesco Corporation and Alesco NZ, in relation to the terms or pricing of the debt and option components of the Notes. Mr Brown identified the fact that the instrument was chosen as a means of documenting the inter-company advances *after* Alesco Corporation had made a decision to acquire the two New Zealand businesses and had already raised its own external funds. Coupled with what he contended was a lack of commerciality inherent in their terms, Mr Brown submitted that the Notes "reflect the sort of artificiality, contrivance and pretence that has been regarded by the Supreme Court as a 'classic indicator' of tax avoidance".[14]

[41] The Commissioner's view is based on economic reality. He asserts that the Notes were no more than "interest free advances stapled to valueless and purposeless warrants".[15] While accepting that Alesco NZ complied to the letter with the financial arrangement rules[16] and the methodology for calculating a notional interest component under G22, the Commissioner considers that such compliance merely

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[12] *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 and *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95, (2011) 25 NZTC 20-073.

[13] While the issues arising straddle the Income Tax Act 1994 and Income Tax Act 2007, there is no material difference in the anti-avoidance provisions of each statute. With the agreement of counsel and to avoid confusion, I refer only to relevant provisions of the Income Tax Act 1994 in this judgment.

[14] *Ben Nevis*, at para [108].

[15] The term "warrant" refers to a "share warrant"; the right to convert Notes into new shares. The expert witnesses agreed that term is more apt to describe the documented arrangement than "share option", even though the latter term is used in the Notes. In this judgment, for consistency with the terms of the Notes, I use the term "option".

[16] These were previously known as accrual rules. See Income Tax Act 1994, Part EH, Division 2 and Income Tax Act 2004, Part EW.

provides the jurisdictional foundation for engagement of the general anti-avoidance provisions. The issue, as in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*, is where "permissible use of specific provisions ends and tax avoidance begins".[17]

[42] Mr Brown submitted that the Commissioner did not undertake a "reconstruction" of the taxpayer's position, under s GB 1 of the Act, and was not required to do so. The Commissioner's view is that s BG 1 operates to annihilate the purported deductions.[18] If that were right, the natural consequence is that the taxpayer must be obliged to repay them and consequential adjustments would be required to address the loss-offset aspects.

[43] The Commissioner seeks to impose shortfall penalties. He does so on the basis that the taxpayer has taken an "abusive tax position".[19] In order to reach that conclusion the Commissioner must demonstrate not only that an "unacceptable tax position" has been taken, but also that the "dominant purpose" of each arrangement was to avoid tax.[20] Shortfall penalties of 100% were imposed, though Alesco NZ receives the benefit of a 50% credit for its prior good tax history.[21] The shortfall penalty thus represents 50% of the interest that was allegedly deducted illegitimately.

[44] For Alesco NZ, it is submitted that there is no tax avoidance arrangement. Mr Lindsay McKay, on its behalf, contended that the financial arrangement rules are designed to deal with a transaction of this type. The Notes complied strictly with those rules. The monetary calculations were made in accordance with the Commissioner's own G22 methodology.[22] Mr McKay also relied on Alesco NZ's application of "Determination G23: Specified Rate" (G23) to demonstrate that it applied the correct discount when calculating the net present value of the debt

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[17] *Ben Nevis*, at para [13].
[18] *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21,323 at paras [152]–[155]. This was the decision from which the *Ben Nevis* appeal was brought but nothing in the Supreme Court judgment contradicts these views.
[19] Tax Administration Act 1994, s 141D.
[20] Ibid, s 141D(1).
[21] Ibid, s 141FB.
[22] See paras [73]–[75] below.

component of each Note. These submissions reflect views expressed by KPMG NZ, in its letter to Alesco Corporation of 27 February 2003.[23]

[45] Alesco NZ's position is that the financial arrangement rules reflect economic reality, by treating notional interest (deductible as an expense) as an economic cost. Mr McKay submitted that Alesco NZ's expert evidence supported the proposition that there was an economic cost to Alesco NZ, even though the terms of the three Notes required Alesco Corporation to advance a total amount of $78 million to Alesco NZ on "interest free" terms.

[46] Alesco NZ takes a different position on reconstruction. Mr McKay contended that the Commissioner had used s GB 1 to reconstruct the arrangement. On that basis, he submitted that the Commissioner has acted on a wrong principle in failing to take account of the next best alternative to the Note funding structure – namely, the provision of a loan at market rates between Alesco Corporation and Alesco NZ, as detailed in evidence given by Mr Fonseca. Alesco NZ contends that there is no "tax advantage" to counteract because, had that alternative method been chosen, Alesco NZ could, legitimately, have claimed greater deductions.

[47] If it were unsuccessful on the first two points, Alesco NZ disputes the imposition of shortfall penalties. It contends that on the state of the law at the time the transactions were entered into and, indeed, in each succeeding year (up to 2008), it was more likely than not that Alesco NZ's tax position was correct. Not only does Alesco NZ dispute that it took an abusive tax position, it also submits that no "unacceptable tax position" was taken; therefore, no shortfall penalties should be imposed.

[48] Two additional points arose during the hearing that require some comment:

(a) First, it became clear shortly before closing submissions that the parties had proceeded on different bases with regard to the reconstruction issue. While the Commissioner took the view that the deductions required repayment as a natural consequence of the

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[23] See para [32] above.

arrangement being void, Alesco NZ contended that the Commissioner had exercised his reconstruction powers under s GB 1 of the Act incorrectly. After hearing counsel, I ruled that I would address the question of reconstruction under both heads but would not determine whether a s GB 1 reconstruction had actually occurred because there was an insufficient evidential foundation to make that factual determination.[24]

(b) Second, in opening, Alesco NZ had contended that s 108 of the Tax Administration Act 1994 applied, thereby imposing a four year time limit on the imposition of shortfall penalties. The Commissioner closed his case on the basis of a signalled submission to that effect. However, Mr McKay, in closing for Alesco NZ, expressly abandoned the time-bar point. In view of that abandonment, I do not consider the point.

**The nature of an optional convertible note**

[49] An optional convertible note evidences both a debt that the issuer may be obliged to repay in cash on maturity and an ability for a holder to opt (at a specific time or otherwise) to receive shares to discharge the debt. The expert evidence satisfies me that there are very limited circumstances in which arm's length investors and issuers would choose to enter into a subscription agreement for an optional convertible note when it is not traded on a transparent public market.

[50] An optional convertible note provides an investor with a reason to accept a lower interest yield in return for the opportunity to participate in any increase in the issuer's wealth at the time of conversion. Conversely, the issuer gains the ability to raise funds at a lower interest cost than would be available in the market. In general terms, use of an optional convertible note may also present opportunities to raise capital on an unlisted basis, to strengthen existing commercial alliances or to provide an employee with the opportunity to benefit from increases in a publicly listed share price.

[24] See Minute (No. 8) dated 26 September 2011 at paras [4] and [5].

[51] In a negotiated arm's length transaction, there is a tension between an issuer's desire both for lower cost debt and preservation of control of the business and an investor's desire to obtain a degree of control over policy and operational aspects of the business, pending the possibility of electing to participate in future wealth. When terms are negotiated at arm's length, the competing tensions are resolved through a process of compromise.

[52] In economic terms, a lower cost of borrowing may be reflected in one of two ways. First, the issuer of the notes may be obliged to pay periodic interest, at defined rests, at a rate lower than the cost of funds in the market. On that basis, the actual value of the debt would be computed by reference to the difference between the rate of interest charged and the market rate. Alternatively, no interest may be payable during the term of the loan (a zero coupon bond) but an implicit interest cost might arise through the need to repay on maturity an amount that exceeds the face value of the debt at the time it is advanced.

[53] In both of those situations, if each party was resident in New Zealand, there is a real economic cost to the issuer:

(a) In the first, the issuer makes periodic payments of interest that are deductible for tax purposes as a business expense. Symmetrically, the holder of the note receives the interest paid as part of its assessable income.

(b) On the alternative model, the debt will accrete in the books of the issuer from its face value at issue to the higher amount at the date of repayment. That interest is, implicitly, a cost to the issuer and is deductible for tax purposes. Symmetrically, the interest component, received implicitly by the holder, is taxable in its hands.

## The Notes

[54] In its engagement letter of 22 January 2003, KPMG advised Alesco Corporation of documentation that it would provide on implementation of its hybrid financial instrument:

> **Documentation provided**
>
> Our fee includes provision of the following documentation specifically tailored to the factual circumstances of [Alesco Corporation].
>
> 1. A detailed implementation workplan.
> 2. A full time project manager.
> 3. A detailed opinion in respect of the Australian income tax and GST.
> 4. A detailed opinion in respect of the New Zealand income tax and GST.
> 5. Legal documentation prepared by KPMG Legal in compliance with both New Zealand and Australian legal requirements.
> 6. Company secretarial minutes prepared by KPMG Legal in respect of the Australian corporate requirements.
> 7. Company secretarial minutes and New Zealand Companies Office filings prepared by KPMG Legal in respect of the New Zealand corporate requirements.
> 8. An accounting opinion in respect of the Australian Statutory Accounting implications, specific to the circumstances of [Alesco Corporation].
> 9. An accounting opinion in respect of the New Zealand Statutory reporting implications specific to the circumstances of [Alesco Corporation].
> 10. A post implementation review.

[55] The terms of the subscription agreements for the Notes were drafted by (or on the instructions of) KPMG. All documentation required to give effect to the transaction was provided by KPMG to Alesco Corporation, as part of a parcel of documents. There was no arm's length negotiation. The directors of Alesco Corporation implicitly adopted the form of the Notes provided by KPMG for its use

and imposed those terms on its subsidiary. The terms were not "agreed" upon in any real sense of that word.[25]

[56] The subscription agreements were governed by New Zealand law. The price of issue was $1.00 per Note. The terms were approximately 10 years from the date of issue, with maturity dates of 31 May 2013 and 30 September 2013 variously. At maturity, the Notes were convertible into ordinary shares in Alesco NZ or could be redeemed for cash at an amount equivalent to the issue price. In combination, the three subscription agreements evidenced an interest free debt of $78 million owed by Alesco NZ to Alesco Corporation, with a conversion option at the end of the term.

[57] Each subscription agreement contained identical provisions. The "main terms" (using the first tranche of Notes issued on 3 March 2003 as an illustration) were:

> 2. **Main Terms of the Issue**
>
> 2.1 The Issuer will on 3rd March 2003 issue 41,000,000 Convertible Notes to the Initial Subscriber at the issue price of $1.00 each, raising total gross proceeds to the Issuer of $41,000,000.
>
> 2.2 The Notes will mature on the Maturity Date.
>
> 2.3 No interest shall be payable on the Notes.
>
> 2.4 The Notes will be evidenced by a note certificate substantially in the form attached to this agreement.

[58] Each instrument gave an option (exercisable only on maturity) to Alesco Corporation to convert some or all of the Notes into shares, at the rate of one share for each Note. Clause 3 provided:

> 3. **Conversion and Redemption**
>
> 3.1 On the Maturity Date, the Subscriber will have the option of Converting all (or such lesser number as may be agreed between the parties) of its Notes into Shares at the rate of one Share for each Note. The Subscriber can elect to Convert its Notes pursuant to this clause by notice in writing to the Issuer, specifying the number of Notes to be Converted on Maturity Date. Shares allotted by the Issuer on Conversion shall be accepted by the Subscriber in full satisfaction of the Issuer's liability in respect of the Principal Value

[25] See also para [113] above.

> of each Note. The option to acquire Shares (through allotment) on Conversion shall not be detachable.
>
> 3.2 The Subscriber will have the option of Redeeming the Notes on the Maturity Date. The Subscriber can elect to Redeem the Notes pursuant to this clause by notice in writing to the Issuer specifying the number of Notes to be Redeemed. Redemption shall be for cash at a rate per Note equivalent to the Principal Value. The Subscriber will then also have the option of utilising all (or any lesser number) of the cash redemption amount to subscribe for shares in the Issuer in consideration for payment of $1.00 per share. This right to subscribe for Shares shall not be detachable or separately transferable.
>
> 3.3 If the Subscriber does not exercise its option to Convert or give notice of its desire to Redeem in accordance with 3.2, the Subscriber shall be deemed to have given notice of Conversion and shall receive on the Maturity Date one Share for each Note.

[59] The effect of cl 3 was to create a default position of conversion. If the subscriber failed to exercise an option to convert (or to give notice of its desire to redeem) the subscriber was deemed to have given notice of conversion and would receive one share for each Note on the maturity date in satisfaction of the debt.

[60] By cl 9.1, Alesco NZ covenanted with Alesco Corporation that:

(a) it would carry on and conduct its business in a proper and efficient manner;

(b) it would notify Alesco Corporation promptly of any event or development which may have a material adverse effect on the ability of Alesco NZ to perform its obligations under the Note;

(c) it would not enter into any major transaction[26] without the prior written consent of Alesco Corporation;

(d) it would not make any distribution to its shareholders without Alesco Corporation's prior written consent; and

[26] As defined in the Companies Act 1993, s 129.

(e) it would not undertake any increase, reduction, consolidation, cancellation or variation of the rights attaching to the shares in Alesco NZ without prior written consent from Alesco Corporation.

[61] The Notes carried no voting rights at meetings of Alesco NZ's shareholders (cl 6) but were "freely transferable subject to the restrictions applicable to transfers of Ordinary Shares set out in [Alesco NZ's] Constitution" (cl 7). Alesco NZ's Constitution contained no such restrictions.

**Unwinding the Notes**

[62] At the time of issue, the directors of the Alesco companies had no intention to change the conditions on which the Notes were issued. Nor was it proposed that they be traded on the open market. However, in 2009, it became clear that the Commissioner intended to introduce a new Determination, "Determination G22A: Optional Convertible Notes Denominated in New Zealand Dollars" (G22A), which was designed to exclude parents and wholly owned subsidiaries from the ambit of G22.

[63] Alesco Corporation was concerned that the proposed G22A would have retrospective effect. It sought advice on how best to deal with this issue. By this time, Biolab had become a very successful business and there were potential buyers in the market. Its business comprised two companies: Biolab, which was wholly owned by Alesco NZ, and Biolab Australia, owned fully by Alesco Corporation. Biolab Australia was initially a subsidiary of Biolab but the latter sold its shares in the Australian company to Alesco Corporation, as part of an internal reorganisation of the Alesco Group in 2005.

[64] The 2008 global financial crisis caused Alesco Corporation to review its portfolio of assets, in the face of its external creditors' desire to lower their exposure to the Alesco group. In December 2008, Alesco NZ began negotiations with potential purchasers for the Biolab companies. On 26 April 2009, the shares in both Biolab and Biolab Australia were sold to the Thermo Fisher Scientific group of companies for a total of $AUD175 million. Subsequently, Biolab was renamed

Thermo Fisher Scientific New Zealand Ltd. The aggregate purchase price was divided between Biolab and Biolab Australia, using a formula based on the earnings before interest and tax of each company.

[65] Mr Stubbs, at material times the Group Tax and Projects Manager of Alesco Corporation, gave evidence of approaching KPMG Australia in April 2009. Advice was sought on the financial reporting and tax consequences of the possible repatriation of surplus capital to Alesco Corporation from New Zealand and the "early unwind" of the Notes. By letter dated 6 May 2009, KPMG Australia identified four possible options for such "unwinding". Between then and 14 September 2009, further advice was obtained on taxation consequences, both in Australia and New Zealand. For various reasons the "unwind project" was put on hold at that time. However, it was reactivated in mid-2010.

[66] Mr Stubbs deposed that, based on an independent valuation of the Notes, Alesco Corporation concluded that the option component of the Notes was "in the money". That was attributable to the increase in value of the Biolab's New Zealand business between acquisition in 2003 (approximately $55 million) and sale (approximately $126 million).

[67] Mr Stubbs gave evidence about the impact of early maturity and conversion from the perspectives of both financial reporting and taxation. Alesco Corporation and Alesco NZ "varied" (in a non-negotiated sense) the maturity dates in each subscription agreement to 30 July 2010. That brought forward the contractual maturity dates of 31 May 2013 and 30 September 2013. On the early maturity date, Alesco Corporation elected to convert the debt into 78 million additional shares. Alesco NZ also performed a "base price adjustment" calculation to identify any income or expenditure under the Notes that had not already been taken into account in applying G22.[27]

[27] See Income Tax Act 1994, s EH 45. See also Susan Glazebrook and others *The New Zealand Accrual Regime – A Practical Guide* (2nd ed, CCH New Zealand, Auckland, 1999) at paras [311] and [313].

[68] By mid-2010, three of Alesco's four sets of proceedings were before this Court.[28] Mr Stubbs deposed that Alesco Corporation was, during this period, "conscious ... of the impact that the early maturity might have on the issues in dispute between Alesco NZ and the Commissioner". He stated that the 2010 transactions were deliberately effected as if Alesco Corporation and Alesco NZ were dealing with each other at arm's length, to meet criticisms made in the pre-litigation phase of the present litigation that neither Alesco Corporation nor Alesco NZ had acted on that basis when the Notes were issued.

## The scheme of G22

[69] Under s 90 of the Tax Administration Act 1994, the Commissioner is empowered to issue "determinations" dealing with specific issues that arise under the financial arrangement rules. Section 90(1)(g) provides:

> **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:

[70] Although G22 was promulgated on 24 October 1990, before the Tax Administration Act 1994 came into force, it is common ground that it continues to apply.[29]

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[28] The fourth, CIV 2011-404-4025, involves shortfall penalties and was issued in 2011.

[29] G22 would have been issued pursuant to s 64E(1)(e) of the Income Tax Act 1976, the predecessor of s 90.

[71] Section 90(2) and (9) of the Tax Administration Act make "determinations" binding on taxpayers and require assessments to be made in accordance with them:

> (2) Any determination made under any of paragraphs ... (g) of subsection (1) shall be binding on persons for the purposes of the old financial arrangements rules.
>
> ...
>
> (9) If a person has applied a determination under subsection (1), an assessment made in respect of the person must be in accordance with the determination.
>
> ....

[72] In the second edition of *The New Zealand Accrual Regime – A Practical Guide*, the learned authors referred to the connection between accrual determinations and financial reporting standards. In the context of a discussion of the policy objectives of closer alignment with accounting principles and practices, they said:[30]

> The final objective of the [accrual] regime was to bring financial reporting closer to reporting for tax purposes. This was to be done except where that objective was not compatible with the other objectives; that is, the matching objective and the objective of ensuring the taxability of all gains on financial arrangements.
>
> In fact, in its early stages the legislation probably imposed new accounting standards in relation to financial arrangements as there had been few specific accounting guidelines for the treatment of financial arrangements before then. The determination-making procedure to some extent duplicated and, in other respects, anticipated the writing of accounting standards.

[73] G22 represents a detailed code dealing with the issues to which s 90(1)(g) of the Tax Administration Act refers. It is directed specifically to optional convertible notes that are denominated in New Zealand dollars and convertible at the option of the holder. Its scope is defined in cl 3:

> **3. Scope**
>
> This determination shall apply to any Convertible Note in relation to which a person is a holder or an issuer where –
>
> (a) All amounts payable are denominated in New Zealand dollars; and
>
> (b) The person becomes a party to the Convertible Note after the day on which this determination is made; and

[30] Susan Glazebrook and others, at para [102].

(c) At the date upon which the Convertible Note is acquired in relation to the holder or issued in relation to the issuer –

(i) The Cash Redemption Amount; and

(ii) The acquisition price and, where the acquisition price is to be paid by instalments, the amount of instalments and instalment payment dates; and

(iii) Coupon Interest Payment dates; and

(iv) The Exercise Date –

in relation to the Convertible note are known not later than the first balance date after the Convertible Note was issued or acquired as the case may be; and

(d) The holder (and not the issuer) of the Convertible Note may elect whether the liability of the issuer is to be discharged by the issue or delivery of shares or by payment of the Cash Redemption Amount; and

(e) The option to acquire shares is not detachable.

[74] Clause 4 of G22 sets out the principles that apply to a financial arrangement issued under this type of optional convertible note:

**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 take into account in any calculations to determine income derived or 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 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.

(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.

[75] The specified rate to be determined when assessing the net present value of the debt component of the instrument is set out in a separate determination in G23. Like G22, it was promulgated before the 1999 amendments to the Act but continues in force.[31] Clause 1(2) of G23 states that the term "rate":

> ... is the market yield applying to Bank Bills of a similar Term to the Term of the financial arrangement; if the Term is longer than 12 months the market yield on New Zealand Government Stock must be used.

**Accounting standards**

[76] At the time that the Notes were issued there were no accounting standards in force in New Zealand[32] that dealt with the way in which they should be reported. However, some standards had been promulgated by the International Accounting Standards Committee. One of those was International Accounting Standard 32: "Financial Instruments Disclosure and Presentation" (IAS 32). Another was International Accounting Standard 39: "Financial Instruments: Recognition and Measurement" (IAS 39). IAS 39 supplemented the provisions of IAS 32.[33] IAS 32 was to be applied in presenting and disclosing information about "all types of financial instruments".[34] The object of the standard was "to enhance financial statement users' understanding of the significance of financial instruments to an entity's financial position, performance and cashflows".[35]

[77] Under IAS 32, a presenter of financial statements is required to classify the component parts of a hybrid instrument either as a liability or as equity, in

[31] See para [70] above.
[32] See also paras [116] and [117] below.
[33] There were two versions of each of IAS 32 and IAS 39 over the relevant period. I refer to the 2004 revised edition, in each case. There are no material differences between the versions and the 2004 standard applied for the greater part of the accounting periods in issue.
[34] IAS 32, para 4.
[35] IAS 32, para 1.

accordance with the substance of the contractual arrangement.[36] Because of the difficulties in ascribing a fair value to each component, the standard requires the debt to be stated at its net present value, with the balance attributed to equity.[37] Therefore, while a methodology is applied to fix the fair value of the debt, the equity entry is derived by simply subtracting that value from the face value of the debt. Because the "equity" entry represents only a balance, it is not necessary for there to be any correlation between the amount attributed to equity and its fair value.[38] The term "fair value" is defined in both IAS 32 and IAS 39:

> **"Fair value"** is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

[78] IAS 39 requires that all financial assets and liabilities be recognised at "the fair value of the consideration given or received to acquire the financial asset or liability (plus certain hedging gains and losses)".[39]

[79] In its financial statements, Alesco NZ disclosed a discounted debt to Alesco Corporation of $78 million (payable in 10 years), applying the appropriate government stock rate. That meant that around $38 million was ascribed to the value of the debt as at the time of the initial contract, with the remaining $40 million being disclosed as equity.[40]

[80] Commentary in Alesco NZ's financial statements explained clearly how the proportions of debt and equity had been assessed, based on the terms of the Notes. Alesco NZ accreted the debt of $38 million each year so that (had the Notes run their course) by the 10th year, a debt of $78 million would have been shown. The amounts used to accrete the debt each year were treated as an interest expense. On that basis, relying on economic cost principles that underpin both the financial

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[36] IAS 32, paras 18, 28–32.
[37] Initially IAS 32 allowed measurement of the debt in equity components separately and pro rata adjustment, but that option was subsequently removed in 2004.
[38] See generally IAS 32, paras 28–32 and AG 30–AG 35.
[39] IAS 39, para 16.
[40] To facilitate comprehension, I have ascribed indicative values to the debt and equity components. In some places specific amounts have been shown that differ from the rounded figures; particularly in evidence of expert witnesses. For example, I refer to Dr Hunt's evidence summarised at para [136] below.

arrangement rules and the financial reporting standards, Alesco NZ claims that an economic cost was incurred and was properly claimable as an interest expense.

**Tax avoidance: legal principles**

[81] On 19 December 2008, the Supreme Court gave two judgments, dealing with the general anti-avoidance provisions of the Act and the Goods and Services Tax Act 1985 respectively: *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*[41] and *Glenharrow Holdings Ltd v Commissioner of Inland Revenue*.[42] Those cases, now to be read in conjunction with *Penny and Hooper v Commissioner of Inland Revenue*,[43] have settled the principles to be applied in New Zealand in cases involving the general anti-avoidance provisions of s BG 1.

[82] Section BG 1(1) provides for circumstances in which an arrangement made by a taxpayer is void as against the Commissioner. It is expressed with deceptive simplicity.

> **BG 1 Arrangement void**
>
> (1) A tax avoidance arrangement is void as against the Commissioner for income tax purposes.

[83] Section BG 1(2) enables the Commissioner to "counteract a tax advantage obtained by" any person under a tax avoidance arrangement. That is done in accordance with Part G of the Act.

[84] In order for s BG 1(1) to apply, the transaction in issue must fall within the definitions of "arrangement", "tax avoidance arrangement" and "tax avoidance". Those terms are defined in s OB 1:

> **OB 1 Definitions**

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[41] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289; application for partial recall of the judgment was subsequently dismissed: NOTE *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] NZSC 40, [2009] 2 NZLR 358.

[42] *Glenharrow Holdings Ltd v Commissioner of Inland Revenue* [2008] NZSC 116, [2009] 2 NZLR 359.

[43] *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95, (2011) 25 NZTC 20-073.

> **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.

[85] A taxpayer may undertake a transaction (or a series of transactions) that fall within specific provisions of the income tax legislation, yet still fall foul of the general anti-avoidance provision. In the majority judgment in *Ben Nevis*,[44] Tipping, McGrath and Gault JJ said:

> [102] It is accordingly the task of the courts to apply a principled approach which gives proper overall effect to statutory language that expresses different legislative policies. It has long been recognised those policies require reconciliation. The approach must ensure that the particular case before the court is examined by reference to the respective legislative policies. It must enable decisions to be made on individual cases through the application of a process of statutory construction focusing objectively on features of the arrangements involved, without being distracted by intuitive subjective impressions of the morality of what taxation advisers have set up.
>
> [103] We consider Parliament's overall purpose is best served by construing specific tax provisions and the general anti-avoidance provision so as to give appropriate effect to each. They are meant to work in tandem. Each provides a context which assists in determining the meaning and, in particular, the scope of the other. Neither should be regarded as overriding. Rather they work together. The presence in the New Zealand legislation of a general anti-avoidance provision suggests that our Parliament meant it to be the principal vehicle by means of which tax avoidance is addressed. The general anti-avoidance regime is designed for that purpose, whereas individual specific

[44] Two judgments were delivered – one on behalf of Tipping, McGrath and Gault JJ; the other for Elias CJ and Anderson J. While they reach the same result, some of the reasoning is different. For convenience, I refer to the judgment of Tipping, McGrath and Gault JJ as the majority judgment.

> provisions have a focus which is determined primarily by their ordinary meaning, as established through their text in the light of their specific purpose. In short, the purpose of specific provisions must be distinguished from that of the general anti-avoidance provision.
>
> [104] Parliament must have envisaged that the way a specific provision was deployed would, in some circumstances, cross the line and turn what might otherwise have been a permissible arrangement into a tax avoidance arrangement. Ascertaining when that will be so should be firmly grounded in the statutory language of the provisions themselves. Judicial attempts to articulate how the line is to be drawn have in the past too often been seized on as if they were equivalent to statutory language. Judicial glosses and elaborations on the statutory language should be kept to a minimum. (footnotes omitted)

[86] I agree with counsel for the Commissioner that four cumulative elements can be distilled, from the majority judgment:

(a) An "arrangement" must exist, into which a taxpayer has entered;

(b) The "arrangement" must use specific provisions of the tax legislation to effect its purpose;

(c) The purpose or effect for which the specific provisions of the legislation have been used must fall outside those contemplated by Parliament;

(d) The use of the specific provisions for a purpose or effect outside Parliament's contemplation must result in a tax advantage-producing purpose or effect that is more than "merely incidental".

[87] While not explicitly analysed in the majority judgment, it appears that the third element is derived from the definition of "tax avoidance arrangement". Their Honours said:[45]

> ... 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.

[45] *Ben Nevis*, at para [109].

[88] In this case, the Commissioner accepts that Alesco NZ claimed interest deductions to which it was entitled on a strict application of the provisions of the financial arrangement rules, including G22 and G23. However, Mr Brown calls in aid *Penny and Hooper*, in which the Supreme Court made it clear that tax avoidance can be found in an individual step in a broader arrangement, even though "entirely lawful and unremarkable" structures have been used to comply with specific taxation provisions.[46] The policy underlying s BG 1 is "to negate any structuring of a taxpayer's affairs whether or not done as a matter of 'ordinary business or family dealings' unless any tax advantage is just an incidental feature".[47]

[89] In *Penny and Hooper*, Blanchard J, for a unanimous Supreme Court, discussed the definition of "tax avoidance arrangement" in the context of a structure that complied strictly with particular provisions of the Act. He said:

> [47] ... [Section BG 1] continues to have work to do whenever a taxpayer uses specific provisions of the Act and otherwise legitimate structures in a manner which cannot have been within the contemplation of Parliament. The policy underlying the general anti-avoidance provision is to negate any structuring of a taxpayer's affairs whether or not done as a matter of "ordinary business or family dealings" unless any tax advantage is just an incidental feature. That must include using a company structure to fix the taxpayer's salary in an artificial manner. ... Woodhouse P said in *Challenge Corporation Ltd v Commissioner of Inland Revenue* that there must be a weapon able to thwart technically correct but contrived transactions set up as a means of exploiting the Act for tax advantages.[48] That is what the artificially low salary settings did in this case. They reduced each taxpayer's earnings but at the same time enabled the company's earnings (derived only because of the setting of the salary levels) to be made available to him through the family trusts. In reality, the taxpayers suffered no actual loss of income but obtained a reduction in liability to tax as if they had, to adapt Lord Templeman's dictum in *Challenge*.[49]
>
> [48] Nor, as the *Challenge* case shows, does the existence in the PSA rules and the cross-border services rules of some specific anti-avoidance provisions have the consequence that s BG 1 cannot operate where the tax avoidance arrangement employed by a taxpayer does not fall within those specific rules. ... Unless the specific rules plainly are intended to cover the field in relation to the use of particular provisions by taxpayers or plainly exclude the use of the general anti-avoidance provision in a certain situation – which is not so here – then the Commissioner can rely upon s BG 1 to counter avoidance where that has occurred.

[46] *Penny and Hooper*, at paras [33] and [34].
[47] Ibid, at para [47], reflecting the definition of "tax avoidance arrangement" in s OB 1 of the Income Tax Act 1994.
[48] *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA) at 532.
[49] *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 555 (PC) at 561.

> [49] ... But what the Act does require of taxpayers is that they should not structure their transactions with a more than merely incidental purpose of obtaining a tax advantage unless that advantage was in the contemplation of Parliament – as it is, for example, in the provisions enabling the setting up of Portfolio Investment Entities (PIEs), through which there can be investment in shares. Parliament must have contemplated and been content that people may structure their transactions for commercial reasons or for family reasons in which any tax advantage is merely incidental, but that they will not be permitted to do so when tax avoidance is more than a merely incidental purpose or effect of the steps they have taken. ...
>
> (some footnotes omitted)

[90] In determining "parliamentary contemplation", a principled approach is required. A rigorous analysis is required to determine the nature and scope of the specific provisions on which the taxpayer has relied to determine whether their use, in the particular case, was permissible. As the majority said, in *Ben Nevis*:

> [106] Put at the highest level of generality, a specific provision is designed to give the taxpayer a tax advantage if its use falls within its ordinary meaning. That will be a permissible tax advantage. The general provision is designed to avoid the fiscal effect of tax avoidance arrangements having a more than merely incidental purpose or effect of tax avoidance. Its function is to prevent uses of the specific provisions which fall outside their intended scope in the overall scheme of the Act. Such uses give rise to an impermissible tax advantage which the Commissioner may counteract. The general anti-avoidance provision and its associated reconstruction power provide explicit authority for the Commissioner and New Zealand courts to avoid what has been done and to reconstruct tax avoidance arrangements.
>
> [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.
>
> [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.

**Tax avoidance: Analysis**

*(a) Tax avoidance*

[91] It is common ground that the Notes constitute an "arrangement" as defined.[50] Although Alesco NZ disputes that the definition of "tax avoidance" is engaged, it is clear that once Alesco Corporation made the decision to acquire the Biolab shares and the Robinson business, its sole motivation was to find and employ the most tax effective structure, whether in Australia, New Zealand, or both.[51] Viewed objectively, the "arrangement" was necessarily one that directly or indirectly relieved Alesco NZ from liability to pay income tax or reduced, directly or indirectly, its liability to income tax through the ability to claim interest deductions and to offset losses among members of its group.[52]

[92] The interest deductions claimed by Alesco NZ benefited the entire Alesco group. So far as the New Zealand members of the group were concerned, it was possible to use the loss offset provisions of the Act to reduce their collective tax burden. The overall tax benefits derived in New Zealand then flowed back to Alesco

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[50] The definition is set out in para [84] above.
[51] See paras [16]–[20] and [24] above.
[52] See the definition of "tax avoidance" in s OB 1, set out at para [84] above.

Corporation, as the overall parent, and improved the group's consolidated balance sheet.[53]

[93] The fact that the Notes were used to finance the acquisitions on the most tax effective terms means that there can be no question in this case of tax advantages being derived on a merely "incidental" basis. If the tax advantages in New Zealand were impermissible, the Notes represent a "tax avoidance arrangement" as defined. The test of whether the tax advantages were permissible is whether Parliament could have contemplated that the financial arrangement rules would be used to obtain interest deductions, in the circumstances of this particular case.

*(b) Purpose of the financial arrangement rules*

[94] At the core of the "parliamentary contemplation" test is the question whether Parliament ever contemplated that the type of transaction undertaken in this case would provide a taxpayer with a right to deduct an "interest" component.

[95] To analyse that issue, it is necessary to compare the purpose of the financial arrangement rules with the way in which the inter-company funding was undertaken in this case. Part of that exercise will require some reference to expert evidence adduced by both Alesco NZ and the Commissioner.

[96] The financial arrangement rules (initially called "accrual rules") were first enacted in 1987, with effect from the 1 April 1985 income year.[54] The rules were re-written extensively in 1999,[55] after a "rigorous consultation process".[56] They were set out in Division 2 of Part EH of the Act and, later, in Part EW of the Income Tax Act 2004.

[97] The 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

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[53] See the highlighted portion of para [30] above.
[54] Income Tax Amendment Act 1987, s 2, inserting ss 64B–64M of the Income Tax Act 1976.
[55] Taxation (Accrual Rules and Other Remedial Matters) Act 1999.
[56] See Susan Glazebrook and others *The New Zealand Accrual Regime – A Practical Guide* (2nd ed, CCH New Zealand, Auckland, 1999) at vii.

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

[98] The purpose of the rules was set out in s EH 20 of the Act:[57]

> **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.

[99] The ability to deduct interest arises from the combined effect of the definition of interest in s OB 1, and in ss BD 2 and DD 1:[58]

> **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 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:
>
> ...
>
> **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

[57] See also para [102] below.

[58] In setting out the provisions, I have added s DB(1)(e), to which reference is made in s DD1(3).

(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) ...

....

**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.

(my emphasis)

[100] The term "financial arrangement" is defined in s EH 22 and the relevant application of those rules is governed by ss EH 23 and EH 24.

**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, ...

...

Although s EH 24(2)(o) is qualified by other words that create a condition precedent to its operation, those criteria are met in this case.

[101] The history of the consultative processes that led to enactment of the accrual rules in 1987 and the changes made in 1999 are discussed in *The New Zealand Accrual Regime –A Practical Guide*.[59] The main aims were:

(a) to require matching (between the parties to a transaction) of income and expenditure recognition for tax purposes and spreading of that income and expenditure over the term of the financial arrangement;

(b) to dilute (and in some cases, abolish) the capital/revenue distinction to ensure that all returns on "financial arrangements" (as defined) are taxable; and

(c) to ensure more consistency between financial accounting and tax accounting.

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

Although specific anti-avoidance provisions are contained within the financial arrangement rules, the text (correctly) indicates that the rules have always been subject to the general anti-avoidance provisions of s BG 1.[60]

[102] In *Commissioner of Inland Revenue v Dewavrin Segard (NZ) Ltd*,[61] the Court of Appeal made some observations about the purpose of the financial arrangement rules. Delivering the judgment of the Court, Gault J said:

> The general scheme apparent from the provisions is that "financial arrangements" as defined and not excepted are brought to tax progressively. There are to be calculated for each income year while they continue such amounts of income and expenditure as are deemed to accrue in that year even though they are unrealised. Various methods are prescribed or provided to enable calculations appropriate for particular types of financial arrangements. By these methods income and expenditure generated by each arrangement are spread across the full term irrespective of how the parties may have structured the arrangement.
>
> In the income year in which a financial arrangement matures, is "remitted" or disposed of there is to be a "base price adjustment" which brings to tax the income and expenditure across the whole period of the arrangement after allowances for all of the deemed income and expenditure taken in under the accrual rules in respect of that arrangement in previous income years. This is in the nature of a "wash up" adjustment.
>
> ...
>
> *The broad object or purpose to be inferred from the provisions is to bring in as assessable for tax income and to allow deduction of expenditure across the term of financial arrangements in which they are earned or incurred. This would overcome avoidance by the loading of expenditure at the commencement of the arrangement and deferring or capitalising income.* (my emphasis)

[103] In *Commissioner of Inland Revenue v Auckland Harbour Board*,[62] Lord Hoffmann for the Privy Council described the general scheme:

> *The general scheme of the regime is to tax the holder of the arrangement on his entire cash inflow less his entire cash outflow.* In the case of a transfer for no consideration, there is no inflow corresponding to the capital value of the arrangement and therefore the net balance is reduced or negative. *On the*

[60] Ibid, at para [600]. For the specific anti-avoidance provisions, see Income Tax Act 1994, ss EH 16, EH 49, GD 11, EH 8 and EH 57. They are discussed at paras [601]–[603] inclusive of the text. See also *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA and PC) in which the opposing view, expressed by Cooke J (at 542) and Richardson J (at 555), was rejected by Lord Templeman's majority opinion in the Privy Council, at 559.

[61] *Commissioner of Inland Revenue v Dewavrin Segard (NZ) Ltd* (1994) 16 NZTC 11,048 (CA) at 11,050–11,051.

[62] *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (PC) at para [13].

> *other hand, the acquisition cost of the transferee is zero and his net balance for tax purposes will be correspondingly higher.* To the scheme there are of course qualifications and exceptions. It is however important to notice that the effect of the Commissioner's proposed use of s 64J(1) [non-market dispositions] is not to tax AHB in accordance with the pure theory of the regime but to introduce what he considers to be another necessary exception or qualification. Such an exception has since been introduced by section 17 of the Taxation (GST and Miscellaneous Provisions) Act 2000 but the Commissioner claims the right to anticipate the legislative amendment. ... (my emphasis)

[104] Lord Hoffmann also approved a description of the regime set out in the first edition of *The New Zealand Accrual Regime*.[63] That passage read:[64]

> [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.

[105] The comments made in *Dewavrin Segard* and *Auckland Harbour Board* emphasise the concept of the accrued amounts matching *real* income and *real* expenditure that are to be realised or incurred at a later stage. Those observations reflect one of the stated objects of the rules; namely, to "prevent deferring income and advancing expenditure".[65]

*(c) The real nature of the transactions effected through the Notes*

[106] The role played by the Notes can be reduced to bare essentials. For the purpose of the following summary, I treat the three tranches of Notes as if they constituted a single document recording the transactions involving the acquisitions of both the Biolab shares and the Robinson business.

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[63] Ibid, at para [2].

[64] Susan Glazebrook and Robin Oliver *The New Zealand Accrual Regime – A Practical Guide* (CCH New Zealand, Auckland) at para [301].

[65] Income Tax Act 1994, s EH 20; set out at para [98] above.

[107] Alesco Corporation decided to acquire the Biolab and Robinson businesses before settling on the way in which the financing arrangements between Alesco Corporation and Alesco NZ would be structured and documented. It was always intended that real money would flow from Alesco Corporation to Alesco NZ. That could have been achieved in a number of ways – for example, by a capital injection, a loan at market interest rates, an interest free loan or an "unbundled" transaction, involving elements of debt and equity.[66]

[108] The way in which the inter-company advances to be made by Alesco Corporation to Alesco NZ were to be structured was driven solely by tax considerations. This was not an "agreement" to lend money on particular terms. It was a way for members of the Alesco group to obtain New Zealand tax benefits, thereby reducing the transaction costs of acquiring the two businesses.

[109] While, in one sense, it could be said that the choice of the financing arrangements between Alesco Corporation and Alesco NZ was commercially driven (on the basis that some financing structure had to be put into place), Alesco Corporation had already made the commercial decision to buy the Biolab and Robinson businesses. Money was raised in Australia for Alesco Corporation to pay for the new assets. The Notes were nothing more than a means of obtaining the New Zealand tax benefits identified by KPMG. The other ways in which the transaction could have been documented involved less tax benefits, either through the operation of Australian or New Zealand tax law.

[110] The use of the Notes as the financing structure of choice is entirely consistent with the notion of Alesco Corporation reducing its transaction costs. That was why advice had been sought from KPMG to ascertain the most "tax effective" structure. KPMG's offer to sell its own HINZ structure to Alesco Corporation evidenced that the dominant purpose of the structure was to procure New Zealand tax advantages.

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[66] See para [126] below, in which a notional "unbundled" transaction is described.

[111] The HINZ structure offered four significant tax advantages to the Alesco group as a whole, three of which arose in consequence of applying New Zealand law:[67]

(a) Alesco Corporation would not receive any interest in cash from Alesco NZ. That meant that Alesco Corporation was not obliged to return income on interest received for Australian tax purposes.

(b) While Alesco NZ had no obligation to pay interest in cash to Alesco Corporation, Alesco NZ could claim a deduction for "interest" expenditure, under the financial arrangement rules.

(c) The interest deduction to be claimed by Alesco NZ could be used to offset income tax payable by members of Alesco NZ's own group of companies. This reduced the amount of tax to be paid by the group.

(d) There was no exposure to the non-resident withholding tax provisions of the New Zealand legislation.

*(d) Artificiality, economic cost and value*

*(i) Artificiality*

[112] At the time the Notes were issued, Alesco Corporation owned 100,000 shares in Alesco NZ. Therefore, Alesco Corporation held 100% of Alesco NZ's capital. Had Alesco Corporation exercised the option, it would have held 78,100,000 shares. Yet, no change to Alesco NZ's status as a wholly owned subsidiary would have been effected. No commercial purpose was served by Alesco NZ providing an option for Alesco Corporation to convert the debt to shares. This aspect of the arrangement was artificial: it was always open for Alesco Corporation to procure the issue of new shares in Alesco NZ, without recourse to the Notes.

[67] See paras [25]–[26] and [29]–[32] above.

[113] In this case, unlike an arm's length transaction, there was no negotiation. A process of negotiation cannot take place when terms of a subscription agreement for an optional convertible note are hoisted on a subsidiary by its parent.[68] In contrast to what occurs in a true negotiation, no account was taken of factors such as the appropriate coupon rate, the number of shares that may be offered to discharge the debt on conversion and the time at which the holder may elect to convert from debt to equity. Rather, the terms of the subscription agreement were crafted to secure the tax advantages promised by the HINZ structure. In that sense also, the arrangement was artificial.

[114] The Notes contained detailed terms designed to mimic those into which arm's length parties would enter.[69] Although, Alesco Corporation had full control over the appointment of directors to the Alesco NZ board and, consequentially, the appointments to be made to the boards of the relevant operating companies, Biolab and Robinhood, the protections "agreed" between parent and subsidiary (and recorded in the subscription agreements) were no more than window dressing, to make the transaction look more justifiable from a commercial perspective.

*(ii) Economic cost*

[115] Mr Simpson presented Alesco NZ's argument on questions of economic cost, by reference to expert evidence given on its behalf by Mr Schubert,[70] Dr Hunt,[71] and Professor van Zijl.[72]

[116] Mr Simpson submitted that the accounting treatment for the transaction met the requirements of IAS 32 and IAS 39. Mr Simpson emphasised that those

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[68] Compare with para [51] above.
[69] See the terms of cl 9.1 of the subscription agreement for the Notes, set out at para [60] above.
[70] Mr Schubert is a partner in PricewaterhouseCoopers with particular expertise in the area of accounting for financial instruments.
[71] Dr Hunt is a New Zealand chartered accountant and an independent financial economic consultant, currently resident in Seattle. His qualifications include a PhD in Financial Accounting from the University of Washington in Seattle and practical experience as an expert in a World Bank arbitration at the International Center for Settlement of Investment Disputes in London. Dr Hunt regarded himself as "an expert on determining the economic effect and valuation of financial instruments" such as the Notes.
[72] Professor van Zijl is a Professor of Accounting and Financial Management at Victoria University of Wellington and was formerly Deputy Chair from 1995 to 1999 and Chair from 2002 to 2003 of the Financial Reporting Standards Board.

standards were designed to reflect the economic substance of a transaction. For Alesco NZ, both Mr Schubert and Professor van Zijl gave expert evidence that, while there were no mandatory standards in force in New Zealand at the relevant time, compliance with IAS 32 and IAS 39 represented application of contemporary "generally accepted accounting practice".[73]

[117] Expert evidence on this topic was given by Professor Jones[74] and Mr Hagen,[75] for the Commissioner. I did not understand them to challenge the views expressed by Mr Schubert and Professor van Zijl on the absence of applicable New Zealand financial standards at the relevant time. They did, however, express differing views on whether IAS 32 and IAS 39 were applicable, on the facts of this case.

[118] Professor Jones took the view that more prescriptive provisions contained in accounting standards applicable in the United States could have been considered. Mr Hagen opined that the transaction represented something more in the nature of a gift of money from a parent company to a subsidiary which did not fall comfortably within IAS 32. Notwithstanding their evidence, I accept that it was open to Alesco NZ to prepare and present its financial statements in accordance with IAS 32.

[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. Using the consolidated financial statements for the year ended 31 May 2004 as an illustration, interest components of the operating expenses were divided into two elements: "interest paid" and "convertible note expense". The former was shown as $225,000 and the

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[73] Financial Reporting Act 1993, s 11(1). That Act also provides that if, in complying with generally accepted accounting practice, the financial statements do not give a true and fair view of the matters to which they relate, such information and explanations as are necessary to give a true and fair view must be added: s 11(2).

[74] Professor Jones is a Professor of Accounting at the University of Sydney, an Adjunct Professor of Accounting at the University of South Australia, and an Editor-in-Chief of a leading international accounting journal that focuses on corporate financial reporting issues.

[75] Mr Hagen is a past Chair of the Financial Reporting Standards Board from 1986 to 1990 and was involved in standard setting processes in New Zealand for about 27 years. He was a corporate finance partner in Deloitte in Auckland.

latter as $2,715,000. The convertible note expense was explained in notes 4 and 13 to the accounts, under the headings of "equity" and "debt component" respectively.

[120] I discussed that presentation with Professor van Zijl, to explore the way in which "interest paid" had been separated from the "notional interest" recorded by reference to the Notes in the financial statements. After a reference to part of his written evidence, the following exchange took place:

> Q. In that heading, and this may be why this came to mind, in your heading you talk about it as describing it as an "interest expense", whereas that's not actually how it's been described in the operating expenses, it's been separated out from interest paid. That's the point I'm asking about.
>
> A. I think the requirement of the standard is to disclose the fact that this kind of interest exists. In that sense, this has been done particularly well, in that there is clear separation between interest paid in other circumstances and interest that derives from the circumstance of the optional convertible notes.
>
> Q. If, for example, that 2.715 had been included within the interest paid, presumably it would have required a note to the accounts which would have explained that 2.175 of the interest paid component is derived from this source?
>
> A. Yes.
>
> ...
>
> **QUESTIONS ARISING FROM MR SIMPSON**
>
> Q. Mr Van Zijl, the narration "interest paid" on page 1541, what [is] that ordinarily understood to mean in accounting parlance?
>
> A. That would be either interest paid, in the sense of actual payments having been made; or interest owing.
>
> Q. It would include interest owing?
>
> A. Yes.
>
> ...
>
> A. It goes back, Sir, to an answer I gave to an earlier question from Mr Simpson, in that had we here had a convertible note that had a positive coupon rate, like say 3%, then you would have seen the 3% under the heading, say, "Interest paid", but the balance of the 4.11% or whatever the other number was would appear as the convertible note expense.

**THE COURT**

Q. Okay. If I go back to the question I asked earlier, just to make sure I don't leave it on an incorrect basis, would it have been acceptable in terms of disclosure to have included the 2.17 figure within interest paid as long as there was a note explaining how that figure was derived?

A. Yeah, the standards require that you disclose but don't specify that it must be on line 3 of page 12 or not lumped in with something else, providing that the reader can, in fact, untangle whatever you've done.

**THE COURT**

Q. So, the answer is yes, as long as the reader understands there is a difference between interest paid with cash going out and interest accrued or, in the notional sense, from the way in which the Accounting Standards -

A. Amortisation interest, yes.

[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.

[122] Alesco NZ's case on economic cost is based on evidence from Mr Schubert and Professor van Zijl, to the effect that a real economic cost was incurred, as recognised by the theory underpinning both G22 and IAS 32.

[123] The Commissioner submits that Parliament contemplated that a tax deduction for interest would be available only in relation to costs incurred "in commercial and economic reality". The Commissioner does not accept that use of the relevant accounting standards is sufficient to establish that particular transactions have real economic substance.

[124] The Commissioner's starting point is the absence of any economic or commercially rational basis for a parent company to subscribe for an interest-free

optional convertible note issued by its wholly owned subsidiary at face value. The Commissioner contends that the Notes are no more than “an interest free advance with a valueless option attached, dressed up in the form of a valuable option and a discounted debt”. Mr Brown submitted that the Notes “do not represent a reasonably available commercial choice to taxpayers as their commercial reality is entirely disconnected from the tax reflex sought”.

[125] Mr Schubert’s approach as to why the interest claimed by Alesco NZ represents a real economic cost over the life of the “interest free” debt was explained succinctly in his written evidence:

> 125. The amount required to extinguish the debt is $78 million in just over ten years’ time. The net present value of that amount (at interest rates of 7.11% for the First and Second Tranche Convertible Notes and 7.34% for the Third Tranche Convertible Notes, representing the cost of borrowing on the issue dates of those tranches) is the amount that Alesco NZ could have borrowed at the time the [Notes] were issued if it had contractually agreed to repay $78 million in just over ten years’ time. That net present value amounted to approximately $38.6 million and represented the fair value of the debt component of the [Notes] (the remainder being allocated to equity).
>
> 126. If we take the total cash obligation required in just over ten 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 [Notes]. It represents the difference between the fair value of the debt at the time the [Notes] were issued and the cash amount that will ultimately be required to extinguish the debt.
>
> 127. 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 represents the economic cost to Alesco NZ of holding debt and has been appropriately recognised as expenditure in the profit and loss account of Alesco NZ. Over the course of the term of the [Notes], the aggregate economic cost of the debt will have amounted to approximately $39.4 million ... This overall economic cost will have had an aggregate negative impact on the net assets of Alesco NZ by the same amount.

[126] Mr Schubert gave evidence that, if the transaction were “unbundled”, its equivalents would comprise:

(a) An issue of shares (or an option to acquire shares) in 10 years time for $40 million; and

(b) A 10 year zero-coupon bond, with a face value of $78 million and an issue price of $38 million.

[127] Mr Simpson supported Mr Schubert's reasoning by submitting that the same result would have occurred if the transaction had been undertaken on an "unbundled" basis, with separate instruments issued for debt and equity.

[128] The Commissioner does not dispute that if Alesco Corporation had injected $40 million into Alesco NZ by way of working capital and issued a 10 year zero coupon bond with a face value of $78 million at an issue price of $38 million, the interest could have been legitimately claimed. The difference between the positions taken by the Commissioner and Alesco NZ is that the Commissioner regards the "unbundled" transaction as including a genuine "implicit interest" cost. He does not accept that the hybrid arrangement contained in the Notes performed the same function. It is clear that the "unbundled" transaction did not take place because of concerns about tax implications in Australia where, in the absence of a hybrid instrument, Alesco Corporation would have been obliged to return the interest component as part of its assessable income.

[129] The opposing position on economic cost was developed in evidence called by the Commissioner from Professor Choudhry[76] and Mr Duignan.[77]

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[76] Professor Choudhry is presently Managing Director, Head of Business Treasury, Global Banking and Markets for the Royal Bank of Scotland plc in London. Before taking up that position, Professor Choudhry was engaged in commercial trading of financial instruments. He holds a position as Visiting Professor at the Department of Economics at London Metropolitan University and is a Visiting Research Fellow at other institutions. Professor Choudhry has published on the subject of debt capital markets, bond and fixed income instruments, and convertible bonds.

[77] Mr Duignan holds a BCA (Hons) (Econ) from Victoria University of Wellington. He has worked for the New Zealand Treasury in various roles and set up the New Zealand Debt Management Office which is responsible for the management of New Zealand's public debt. He has also undertaken Treasury functions in a number of investment banking companies. Mr Duignan now provides corporate finance and economics advice within the public and private sector, in which he has experience with OCNs. Since 2004, he has been a member of the Investment Committee of the Accident Compensation Corporation and is presently a full member of the Commerce Commission.

[130] Professor Choudhry's evidence was that not only was no economic cost incurred by Alesco NZ but, in fact, it obtained an economic benefit through its ability to use the $78 million received from Alesco Corporation for its own purposes, pending repayment or conversion to equity on maturity. He saw no commercial reason for a wholly owned subsidiary to issue an optional convertible note to its parent company at par, because the parent already owned 100% of the issued share capital.

[131] I accept Professor Choudhry's views on this topic. My focus is on the economic reality of the transaction. There was no economic cost actually incurred. Rather, Alesco NZ had the use of an interest free loan from its parent from the time of advance to the maturity date. Alesco NZ, as a result of the subscription agreements, would not (and did not) incur any actual expense on an annual basis during the period from the issue of the Notes until maturity.

*(iii) Did the option component of the Notes have economic value?*

[132] Alesco NZ contended, in reliance on evidence from Dr Hunt to establish the likely value of the Notes to an independent arm's length third party, for the purpose of demonstrating that they had an intrinsic economic value. Applying two generally accepted option pricing models, Dr Hunt opined that a third party might buy the Notes for something in the order of $34 million. In contrast Professor Choudhry could not identify any reason why an arm's length third party would want to buy the Notes. In concluding his written evidence on this point, Professor Choudhry said:

> 47. As long as the Alesco NZ [Notes] stay in the hands of the parent [they are] only ever in economic substance an interest-free loan. The option element carries no practical value or purpose, because the parent already owns the issuer. The Alesco NZ [Notes] might in theory be sellable to a third party investor but ... I do not consider sale to a third party to be a realistic proposition.
>
> 48. Given the factors I have outlined above, it is difficult not to conclude that the Alesco NZ [Notes] were never intended to be sold to any third party. This is because I do not consider it realistic to assume that a third party purchaser would ever present itself. I accordingly consider that for all practical intents and purposes the warrant component of the Alesco NZ [Notes] had no value at the time of issue. The [Notes] have been termed "[Notes]" in their legal documentation, but they are really simply interest-free loans from

> the parent to the subsidiary, with an option to turn that interest-free loan into an injection of equity capital on maturity.

[133] Mr Duignan described the issue of convertible notes in New Zealand as "infrequent". That, he suggested, reflected the limited number of listed companies and the associated paucity of equity issues. Mr Duignan identified five "typical characteristics" of "orthodox publicly issued" optional convertible notes, observing that the Notes contained none of those features.

[134] Mr Duignan regarded the Notes as uncommercial. He identified a number of "unusual features" that suggested that they were not "fit for purpose", in the sense of what one would expect of a commercial issue on a transparent market.

[135] Like Professor Choudhry, Mr Duignan saw no need for a parent to subscribe to a Note issued by a wholly owned subsidiary. Mr Duignan explained that the only way in which the parent could obtain value from the option would be to sell the Note before maturity. In a case where no preparation for a sale to a third party has been undertaken and "definitively where the terms of the [Notes] are contrary to commercial norms and thus an obstacle to sale", Mr Duignan considered "it would be illogical to attribute any consideration received by a wholly owned subsidiary for issuing [Notes] to its parent to the optional component of the [Note]".

[136] Dr Hunt's evidence, based on cross checking involving three valuation methodologies, was that the option component of the Notes had significant economic value to an arm's length third party wishing to purchase them:

> 103. I do this in three ways. **First,** I use the mean average implied volatility obtained across all three comparable companies for which I can observe implied volatilities. I use this 22.4% average implied volatility as a relevant volatility point estimate for computing an indicative value of the [Notes'] option component. I then compare this indicative value with $34.7 million. **Second,** I compute the combinations of underlying net asset value and volatility parameters that are consistent with the [Notes'] warrant's $34.7 million tax value. I then observe whether reasonable values for volatility parameters and underlying asset value imply warrant values above or below the line that depicts a $34.7 million warrant value. I describe this as an isoquant approach, in that it establishes a series of parameter values for which the warrant value is constant. It is this approach that is central to my statement and its conclusions. **Third,** I develop a simulation as a confirming approach. A simulation

> approach to valuing the warrant component of the [Notes] enables me to explicitly examine the expiry of two [Notes] at 31 May 2013 and the third at 30 September 2013.

[137] Much of the expert evidence called by Alesco NZ is undoubtedly correct in theory. For example, as Professor van Zijl said, there was no need to differentiate, for reporting purposes, between Notes issued at arm's length or between parent and subsidiary. The accounting treatment will be the same, either way. That is because the accounting standards do not contemplate different treatment for related party transactions, other than disclosure of the relationship. All that is required is that the reader understands what is going on.

[138] In similar vein, while I do not doubt the arithmetical correctness of the valuation reached by Dr Hunt on the basis of his three methodologies, all are directed to a circumstance in which an option is traded on a transparent market. That did not occur, in this case.[78]

[139] In my view, Dr Hunt's evidence that an arm's length third party might have purchased the Notes for a sum of around $34 million[79] is unsupportable, on any commercial analysis.

[140] In the course of his oral evidence, Dr Hunt acknowledged the need for any purchaser to enter into a separate negotiation with Alesco Corporation to ensure that an acceptable form of governance was put into place to protect the purchaser's interests during the currency of the arrangement. He accepted that such arrangements would revolve around voting rights and that a purchaser was unlikely to acquire the Notes if it could exert no influence over the way in which Alesco NZ or the operating companies were run, pending repayment of the debt or conversion.

[141] When it was put to Dr Hunt that the fortunes of Alesco NZ depended on the way in which the boards of the two asset holding companies (Biolab and Robinhood)

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[78] Compare with Mr Duignan's evidence, summarised at para [135] above.

[79] See para [136] above. Dr Hunt went so far as to say that if he were offered the Notes in their current form at the value ascribed by G22/G23, he "would go to a private equity fund and ... try and buy" them, believing that they were "a desirable deal" at approximately $34 million.

conducted their affairs, he acknowledged that their relationship with Alesco NZ was "important". The issue of "control" was developed in a question I put to him:

> **THE COURT**
>
> Q. ... Just to tease that out a little more, there may be rights of Alesco, for example, Alesco New Zealand, to remove directors and so forth in the operating companies but the board of those operating companies could do something in the meantime that causes loss of value over which Alesco New Zealand as shareholder would not have direct control. That's the reason why I'm suggesting to you that it may be the control of the board of the operating companies that is more important in relation to the control that you would need coincidental to acquisition of the notes?
>
> A. Yes, I think you're absolutely right. We have to assume that Alesco New Zealand has got its governance right with its subsidiaries. I guess the issue that was set before me was about ownership of Alesco New Zealand but I do agree, regardless of who owns a residual claim over Alesco New Zealand, we have to assume that Alesco New Zealand has appropriately structured its governance over its subsidiaries.

[142] In my view, there could be no commercial benefit to any arm's length investor (not engaged in speculation) in acquiring the Notes independently of the shares in Alesco NZ. If the Notes were acquired, the purchaser would have had the right to be paid $78 million in however many years remained to run or to obtain about 99% control of Alesco NZ, through the swamping effect of the options.[80] However, without some separate arrangement with regard to control of the boards of both Alesco NZ and the profitable operating subsidiaries, a purchaser could not be sure that its investment would have value at the end of its term. Nor could it be certain that sufficient funds would be available to repay the debt, if conversion were not effected.

[143] While cl 9.1 of the Notes[81] would give a purchaser a degree of protection in the context of an intended sale, the covenant bound only Alesco NZ. It did not bind the profitable operating subsidiaries from which profits were being generated for the benefit of the group as a whole.

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[80] See para [112] above.
[81] See para [60] above.

[144] The correctness of this proposition can be tested by considering what incentive Alesco Corporation would have to sell the Notes and to yield control pending exercise of the option to seek repayment or convert. The likelihood is that Alesco Corporation would not be prepared to contract on that basis because it would risk the possibility of diminution in the value of Alesco NZ's assets through the way in which the profitable operating subsidiaries' business was undertaken. Depending on management decisions made, Alesco NZ may or may not have been in a position to repay the $78 million debt on due date.

[145] The need for Alesco Corporation and a potential arm's length purchaser to negotiate important terms that went beyond the rights inherent in the terms of the subscription agreements provides compelling evidence that the Notes could not have been sold to an unrelated entity for anything more than a minimal amount that a speculator may have been prepared to pay.

*(e) Were the deductions claimed within Parliamentary contemplation?*

[146] Any taxpayer is entitled to structure its affairs to minimise its tax obligations by "permissible" means. The issue in this case is whether the New Zealand tax advantages achieved, through the HINZ structure, were permissible or impermissible.[82] In undertaking that analysis, the label given to a particular transaction by the parties is not determinative.[83] Rather, it is necessary to "consider the use made of the specific provision in the light of the commercial reality and the economic effect of that use".[84]

[147] I hold that the interest deductions claimed were not contemplated by Parliament because:

(a) There was an absence of any match between expenditure incurred and income to be returned. The terms of the subscription agreement were not negotiated but were designed to enable Alesco NZ to claim

[82] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at paras [106] and [107] (Tipping, McGrath and Gault JJ), set out at para [90] above.
[83] Ibid, at para [48].
[84] Ibid, at para [109].

interest deductions, without any corresponding return of taxable income.[85]

(b) The arrangement was an artificial device designed only to secure a tax advantage in New Zealand that could not otherwise have been obtained.[86]

(c) No real interest expense was incurred and the notional interest claimed did not represent a real economic cost.[87] Further, the Notes had no inherent commercial value to an arm's length third party, other than (perhaps) a speculator.[88]

[148] I find that tax avoidance has been established.

**Reconstruction issues**

*(a) Introductory comments*

[149] The next question is how the impermissible tax advantages should be counteracted.

[150] A preliminary issue is whether the Commissioner has required repayment of the deductions claimed as a natural consequence of his assessment based on s BG 1 or on reconstruction of the taxpayers' affairs under s GB 1.[89] I address this issue on both bases.

*(b) The competing positions*

[151] The Commissioner takes the view that, once an arrangement is treated as void under s BG 1, he is entitled to determine how to counteract the tax advantage gained. On any challenge to his assessment, the Taxation Review Authority or this

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[85] See para [101](a), [102]–[105] above.
[86] See paras [112]–[114] above.
[87] See [124]–[131] above.
[88] See paras [132]–[145] above.
[89] See para [48](a) above.

Court has power to vary that decision. Section 138P of the Tax Administration Act 1994 states:

> **138P Powers of hearing authority**
>
> (1) On hearing a challenge, a hearing authority may—
>
> (a) Confirm or cancel or vary an assessment, or reduce the amount of an assessment, or increase the amount of an assessment to the extent to which the Commissioner was able to make an assessment of an increased amount at the time the Commissioner made the assessment to which the challenge relates; or
>
> (b) Make an assessment which the Commissioner was able to make at the time the Commissioner made the assessment to which the challenge relates, or direct the Commissioner to make such an assessment.
>
> (1B) If a taxpayer brings a challenge and proves, on the balance of probabilities, that the amount of an assessment is excessive by a specific amount, a hearing authority must reduce the taxpayer's assessment by the specific amount.
>
> ...
>
> (3) Subject to subsection (4), the Commissioner must make or amend an assessment or other disputable decision in such a way that it conforms to the hearing authority's determination.
>
> (4) The Commissioner is not required to make or amend an assessment or other disputable decision before the resolution of appeal procedures from the hearing authority.
>
> ....

[152] Whether or not a formal reconstruction is undertaken pursuant to s GB 1 of the Act, the test that s 138P applies remains relevant to any assessment made by the Commissioner following invocation of s BG1. Section GB 1 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 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.

(2B) For the purpose of subsection (2A), the Commissioner may have regard to the credits of tax which the taxpayer or another taxpayer would have had, or might have been expected to have had, if the arrangement had not been made or entered into.

(2C) In this section, credit of tax means the reduction or offsetting of the amount of tax a person must pay because—

(a) credit has been allowed for a payment of any kind, whether of tax or otherwise, made by a person; or

(b) of a credit, benefit, entitlement or state of affairs.

(3) Without limiting the generality of the definitions of “arrangement”, “liability”, “tax avoidance” or “tax avoidance arrangement” in section OB 1, or of section BG 1 or subsections (1) and (2) of this section, where, in any income year, any person sells or otherwise disposes of any shares in any company under a tax avoidance arrangement under which that person receives, or is credited with, or there is dealt with on that person’s behalf, any consideration (whether in money or money’s worth) for that sale or other disposal, being consideration the whole or a part of which, in the opinion of the Commissioner, represents, or is equivalent to, or is in substitution for, any amount which, if that arrangement had not been made or entered into, that person would have derived or would derive, or might be expected to have derived or to derive, or in all likelihood would have derived or would

> derive, as dividends in that income year, or in any subsequent income year or years, whether in one sum in any of those years or in any other way, an amount equal to the value of that consideration, or of that part of that consideration, shall be deemed to be a dividend derived by that person in that first-mentioned income year.

[153] The difference between the Commissioner's approach and that taken by the taxpayers is that the Commissioner contends that he has a discretion to counteract the tax advantage as he thinks fit, whereas the taxpayers contend he is obliged to apply the next best alternative to the transaction undertaken.

*(c) The Court's jurisdiction on reconstruction*

[154] On either approach, any challenge to the Commissioner's reconstruction falls to be considered against the advice of the Privy Council in *Miller v Commissioner of Inland Revenue*.[90] Counsel for the taxpayers there had submitted that the Commissioner had wrongly treated as remuneration money received under a scheme that was void on the basis of a predecessor to s BG 1. Lord Hoffmann, for the Board, said:

> [22] Their Lordships consider that this argument is based upon a misapprehension about the effect of a reconstruction. The Commissioner's duty is to make an assessment with regard to what in his opinion was likely to have happened if there had been no scheme. But that does not mean that he is actually rewriting history. The reconstruction is purely hypothetical and provides a yardstick for the assessment. ...

[155] Mr McKay submitted that Lord Hoffmann's approach required the Commissioner to act on Mr Fonseca's evidence that if the Notes had not been used to structure the intra-group transaction, an interest bearing debt would have been employed, meaning that greater claims for interest could have been made. Mr McKay submitted that Lord Hoffmann's remarks have the effect of mandating acceptance of the taxpayers' position.

[156] With respect, I disagree. It is clear that once the arrangement is treated as void under s BG 1, the purpose of the Commissioner's decision to reconstruct is to

[90] *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 (PC); see also *Miller v Commissioner of Inland Revenue* [1999] 1 NZLR 275 (CA) at 302.

"counteract any tax advantage" achieved by the taxpayers.[91] Even if Mr Fonseca's evidence is accepted (the best position from Alesco NZ's perspective), Lord Hoffmann's observations simply demonstrate that is the "yardstick" by which the Commissioner must make his assessment.

[157] The fallacy in Alesco NZ's argument is that impermissible claims for interest deductions are not *counteracted* if the Commissioner were to treat Alesco NZ as having entered into an interest bearing loan. No such loan was entered into. No interest expense was incurred. The parties could have agreed on an interest bearing loan but they did not do so. That did not happen, probably because of the adverse tax consequences (paying tax on the interest received) for Alesco Corporation in Australia.

[158] It is artificial for Alesco NZ to suggest now that the Commissioner ought to pretend that an interest bearing loan was made to allow Alesco NZ to keep the benefit of the improper deductions it claimed.

[159] Further, as a matter of logic, it is not possible to counteract a tax advantage by allowing the taxpayer to obtain greater tax benefits than were actually achieved. Alesco NZ's premise never existed and was never likely to exist.[92]

[160] On either approach, I consider that s 138P of the Tax Administration Act would have provided the jurisdiction for this Court to alter the Commissioner's assessment had there been any basis to do so. As there is none, no relief can be granted under that provision and, subject to the issues involving shortfall penalties, the Commissioner's assessments stand.

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[91] Income Tax Act 1994, s GB 1(1).

[92] See *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21,323 at paras [152]–[155]; aff'd *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at paras [169]–[171].

**Shortfall penalties**

*(a) The assessments*

[161] The Commissioner took the view that Alesco NZ's tax position was both "unacceptable" and "abusive", under s 141D of the Tax Administration Act 1994. The shortfall penalty imposed equates to 50% of the tax deductions. The 100% penalty that would otherwise be imposed for taking an abusive tax position has been reduced by 50% on account of Alesco NZ's prior history of good tax compliance.[93]

[162] The shortfall penalties have been imposed in respect of the interest deductions throughout the 2003 to 2008 tax years. The Commissioner submits that if he were wrong in imposing a 100% penalty for taking an abusive tax position, then a 20% penalty ought to be imposed under s 141B for taking an "unacceptable tax position". Proof of an "unacceptable tax position" is required as a pre-condition to a finding that an abusive tax position has been taken.[94] Alesco NZ's position is that the criteria for imposing shortfall penalties, whether under ss 141B or 141D, have not been made out.

*(b) The statutory provisions*

[163] Sections 141B and 141D, at the relevant times, provided:

> **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.
>
> …
>
> (2) A taxpayer is liable to pay a shortfall penalty if the taxpayer takes an unacceptable tax position and the tax shortfall arising from the taxpayer's tax position is more than both—
>
> (a) $20,000; and

[93] Tax Administration Act 1994, s 141FB.
[94] Ibid, s 141D(1).

(b) the lesser of $250,000 and 1% of the taxpayer's total tax figure for the relevant return period.

…

(4) Where subsection (2) applies, the shortfall penalty payable is 20% of the resulting tax shortfall.

(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.

(6) The time at which a taxpayer takes a tax position for a return period is—

(a) the time at which the taxpayer provides the return containing the taxpayer's tax position, if the taxpayer provides a tax return for the return period:

(b) the due date for providing the tax return for the return period, if the taxpayer does not provide a tax return for the return period.

(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).

…

**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**).

(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.

[164] The terms "tax position" and "tax shortfall" are defined in s 3(1) of the Tax Administration Act:

**tax position** means a position or approach with regard to tax under one or more tax laws, including without limitation a position or approach with regard to—

…

(g) The incurring of an amount of expenditure or loss, or the allowing or denying as a deduction of an amount of expenditure or loss:

(h) The availability of net losses, or the offsetting or use of net losses

...

**tax shortfall**, for a return period, means the difference between the tax effect of—

(a) A taxpayer's tax position for the return period; and

(b) The correct tax position for that period,—

when the taxpayer's tax position results in too little tax paid or payable by the taxpayer or another person or overstates a tax benefit, credit, or

> advantage of any type or description whatever by or benefiting (as the case may be) the taxpayer or another person:

[165] The standard and onus of proof, when shortfall penalties are in issue, are set out in s 149A of the Tax Administration Act 1994:

> **149A Standard of proof and onus of proof**
>
> (1) The standard of proof in civil proceedings relating to the imposition of penalties is the balance of probabilities.
>
> (2) The onus of proof in civil proceedings—
>
> (a) Relating to evasion or similar act to which section 141E applies or to obstruction rests with the Commissioner:
>
> (b) Relating to any other matter or thing rests with the taxpayer.
>
> …

[166] In summary, Alesco NZ bears the onus of proving, on a balance of probabilities, that the tax position it took was neither "unacceptable" nor "abusive".

*(c) The purpose of the shortfall penalty provisions*

[167] In *Ben Nevis*, the Supreme Court considered the nature and purpose of the regime of civil penalties applicable to taxpayers who failed to comply with their tax obligations, in the context of a self-assessment regime.[95] Tipping, McGrath and Gault JJ (with whom, on this point, Elias CJ and Anderson J did not disagree) said:

> [174] The scheme of Part 9 [of the Tax Administration Act 1994] is to impose civil penalties on taxpayers who take an incorrect tax position which results in a tax shortfall. The provisions impose specified penalties, based on varying percentages of the resulting tax shortfall, which are set by the statute itself, according to the relative culpability of the taxpayer. At one end of the scale are instances where the taxpayer has not taken reasonable care where the penalty is 20 per cent. Where the taxpayer is grossly careless, the penalty is 40 per cent. At the other end is evasion, where the penalty is 150 per cent. In the appellants' case the penalties were imposed under s 141D, which applies where the taxpayer has taken an "abusive tax position". The penalty in such cases is 100 per cent of the tax shortfall.
>
> ...

[95] *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at paras [172]–[174].

> [177] The penalty provisions, particularly at the higher end of the scale, are onerous. This reflects Parliament's statement of the purposes of Part 9, which are:
>
> (a) To encourage taxpayers to comply voluntarily with their tax obligations and to co-operate with the Department; and
>
> (b) To ensure that penalties for breaches of tax obligations are imposed impartially and consistently; and
>
> (c) To sanction non-compliance with tax obligations effectively and at a level that is proportionate to the seriousness of the breach.
>
> [178] The broad statutory goal of the penalty provisions is to secure compliance by taxpayers with their legal obligations in relation to the positions they take regarding their tax affairs. Part 9 supports the integrity of the tax system in its dependence on voluntary compliance by taxpayers with their responsibility to inform the Revenue concerning their tax affairs in a proper and accurate way. It provides sanctions which increase in severity according to the gravity of the circumstances of what the legislation treats as inappropriate tax positions. These sanctions create strong incentives for taxpayers to meet standards of conduct in their tax affairs, in particular in relation to tax positions that may be characterised as involving tax avoidance or evasion. (footnotes omitted)

### *(d) "Unacceptable tax position"*

[168] In considering whether a taxpayer has taken an "unacceptable tax position" the Court must determine whether "viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct".[96] That phrase was considered by the Supreme Court in *Ben Nevis*. The discussion and analysis of shortfall penalty issues is found in the majority judgment. On these issues, nothing said by the minority suggests a different approach.

[169] The Supreme Court held that the expression "about as likely as not to be correct" (in s 141B(1)) did not require proof that the tax position had a prospect of success of at least 50%, but that the merits of the argument supporting the taxpayer's interpretation ought to be "substantial".[97] The Supreme Court emphasised that the need to assess the likelihood "objectively" meant that "the taxpayer's belief that the position taken was correct, or not unacceptable, is irrelevant".[98] The Court accepted that the necessary assessment required "a judgment of the weight of the arguments

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[96] Ibid, s 141B(1).
[97] *Ben Nevis*, at para [184].
[98] Ibid.

that support the taxpayer's position in the application of the law to the relevant facts", taking into account the matters to which s 141B(7) refers.[99] In determining whether a taxpayer has taken an "unacceptable tax position", I am required to have regard to all relevant tax laws and any judicial decisions interpreting them issued up to one month before the taxpayer took its tax position.[100]

[170] In *Ben Nevis*, a case involving returns of income for the 1998 tax year, the Supreme Court assessed the likelihood of correctness of the taxpayer's position by reference to two decisions of the Privy Council arising out of the *Europa Oil* litigation, delivered in 1970 and 1976 respectively.[101] In the present case, Mr McKay urged me to assess the question of likelihood against the Privy Council's decision in *Commissioner of Inland Revenue v Auckland Harbour Board*,[102] a case that Mr McKay contended was both more analogous and proximate to the time at which the taxpayer took its position, in 2003.

[171] In *Ben Nevis*, counsel for the taxpayers had argued that observations made by the majority in *Europa 2* provided a basis for the tax position taken in that case. He relied on part of the majority opinion given by Lord Diplock (on behalf of himself, Viscount Dilhorne, Lord Edmund-Davies and Sir Garfield Barwick):[103]

> Their Lordships' finding that the monies paid by the taxpayer company to Europa Refining is deductible under s 111 [of the Land and Income Tax Act 1954] as being the actual price paid by the taxpayer company for its stock-in-trade under contracts for the sale of goods entered into with Europa Refining, is incompatible with those contracts being liable to avoidance under s 108. In order to carry on its business or marketing refined petroleum products in New Zealand the taxpayer company had to purchase feedstocks from someone. In respect of these contracts the case is on all fours with *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* ... in which it was said by the High Court of Australia 'it is not for the Court [or] the commissioner to say how much a taxpayer ought to spend in obtaining his income" ... to which their Lordships would add: it is not for the court or commissioner to say from whom the taxpayer should purchase the stock-in-

[99] Ibid, at para [185], approving similar observations made by Hill J in *Walstern Pty Ltd v Commissioner of Taxation* (2003) 138 FCR 1 (FCA) at para [108]. See s 141B(7), set out at para [163] above.
[100] Income Tax Act 1994, s 141B(7).
[101] *Commissioner of Inland Revenue v Europa Oil (NZ) Ltd* [1971] NZLR 641 (PC) *[Europa 1]* and *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546 (PC) *[Europa 2]*.
[102] *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (PC). The Board's advice was delivered on 24 January 2001.
[103] *Europa 1*, at 556.

> trade acquired by him for the purpose of obtaining his income. (citations omitted)

[172] The Supreme Court did not accept that this passage was authority for the propositions that "a legal entitlement gained under a contract from expenditure qualifies that expenditure for deductibility under tax law" and "a general anti-avoidance provision cannot apply to bar the deduction".[104] Tipping, McGrath and Gault JJ said:

> [190] It was, however, by no means clear from its judgment that the observations of the Privy Council were intended to state such a broad proposition that would be applicable in all situations. Prior to the Privy Council's judgment the New Zealand courts had held in *Elmiger* and *Wisheart* that the Commissioner could apply s 108 to avoid arrangements involving contrived deductions in artificial situations which had the principal end of reducing tax otherwise payable, even though on a purely legal analysis of the arrangement the expenditure in issue was deductible under a specific tax provision. In *Mangin*, the Privy Council appeared by its general approach to have approved the opinions expressed in the Court of Appeal's judgment in *Elmiger*.
>
> [191] In adopting the *Cecil Bros Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* approach in *Europa 2*, the Privy Council made no reference to its earlier approval of *Elmiger* in *Mangin*. Nor did it refer to the Court of Appeal judgment in *Wisheart* refusing to apply *Cecil Bros* in a case involving a highly artificial arrangement. *The Privy Council's conclusion of incompatibility rested on the factual finding that the taxpayer had actually paid the price claimed as a deduction. The judgment did accept that there might be wider considerations in other cases that would lead to a conclusion of tax avoidance. This suggests that the Privy Council was not overruling the earlier New Zealand decisions and did not intend its observations to be read as applicable to arrangements of a contrived or artificial kind.*
>
> [192] Consistently with this narrower view of Lord Diplock's observations in *Europa 2*, Casey J held in 1977 that the Privy Council had not determined that s 108 could never apply to deductions falling within s 111. He concluded that there was an area in which s 108 continued to operate in appropriate cases to avoid deductions conforming with s 111. After referring to passages in *Cecil Bros* and *Europa 2*, Casey J explained how s 108 should be applied in deduction cases:
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>> "Where the need for the expenditure can be regarded as a normal incident of the business or undertaking forming the source of the taxpayer's income, then he may select his own means of incurring it, and may spend what he thinks fit. So long as that expenditure conforms with s 111, it cannot be attacked under s 108. But s 108 can still apply where the need for such expenditure has been contrived in an existing source of income, as part of an arrangement

[104] *Ben Nevis*, at para [189].

> having tax avoidance as one of its main purposes, and which is not a usual business or family dealing."

(footnotes omitted, emphasis added)

[173] The Supreme Court went on to consider other decisions given before the 1997 and 1998 returns made by the *Ben Nevis* taxpayers; namely, *Challenge Corporation Ltd v Commissioner of Inland Revenue* (in both the Court of Appeal and Privy Council),[105] *Hadlee v Commissioner of Inland Revenue*[106] and *Miller v Commissioner of Inland Revenue*.[107] The Court also considered whether it would assist the taxpayers if it were to consider the later decisions of the Court of Appeal and Privy Council in *Commissioner of Inland Revenue v Peterson*.[108] The majority said:

> [196] In a judgment delivered in the High Court in 1997, the scope of the application of the anti-avoidance provision in deductibility cases was further clarified. In *Miller v Commissioner of Inland Revenue* Baragwanath J referred to *Europa 2* and said that Lord Diplock's reference to "incompatibility" appeared to turn on the Privy Council's reluctance to review decisions that may be justified on commercial grounds. After observing that the Privy Council in *Challenge Corporation* had declined to treat s 191 (a specific anti-avoidance provision) as establishing a code independent of s 99 [the general anti-avoidance provision under the Income Tax Act 1976], Baragwanath J, in an observation which we consider accurately summarised the legal position reached at the time, said:
>
> > "It is a section that deals with transactions altogether lawful in terms of the general law and the general provisions of the Income Tax Act but which nevertheless infringe its terms. Section 99 does concern reality and lawfulness, but in a sense quite different from the general provisions. It begins to bite when their operation is complete."
>
> [197] The appellants' tax returns for the 1997 and 1998 years were filed and their tax positions in relation to the Trinity scheme taken against these interpretations of the relevant tax laws. *Even in 1976, while objectively tenable, it was by no means clear that the Privy Council had intended its observations to apply to cases of contrived deductions or artificial situations lacking any apparent commercial purpose. But by the time the tax positions were taken in the present case, the proposition that the New Zealand courts, including the Privy Council, would have reverted to the simplistic and very restrictive approach to the application of s 99, based on a literal reading of Europa 2, was remote, given the less than sympathetic treatment that case had received subsequently*.

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[105] *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA and PC).
[106] *Hadlee v Commissioner of Inland Revenue* [1991] 3 NZLR 517 (CA)
[107] *Miller v Commissioner of Inland Revenue* (1997) 18 NZTC 13,001 (HC).
[108] *Commissioner of Inland Revenue v Peterson* [2003] 2 NZLR 77 (CA); rev'd [2006] 3 NZLR 433 (PC).

> [198] Nor would it assist the appellants if the Court were to consider the later decision in *Peterson*. The Court of Appeal discussed the principles in *Cecil Bros* and *Europa 2* and observed:
>
> > "But we find nothing in the judgments in those cases precluding the Commissioner from declining to recognise costs not truly incurred."
>
> [199] Our approach to *Europa 2* is consistent with the judgment of the Privy Council in *Peterson*, although the taxpayer's appeal was successful in that case. In *Peterson* the Privy Council, by a majority, applied the approach it had taken to trading expenditure in *Europa 2* to capital expenditure incurred to acquire rights to a film. The taxpayer in *Peterson* had claimed a depreciation allowance based on the total sum he was contractually required to pay to acquire the interest in the film. Part of the consideration was a contrived sum, which was financed by a non-recourse loan, that had no relationship to production costs and indeed was immediately repaid to the lender. The majority, in the judgment of Lord Millett, decided the appeal on the basis of a concession of fact made by the Commissioner that contractually the taxpayer had paid the full consideration to acquire the film, there being no additional purpose. In these circumstances, the majority applied the *Europa 2* principle to determine the appeal in favour of the taxpayer. (footnotes omitted, emphasis added)

[174] In *Ben Nevis*, the taxpayers contended that, by satisfying the specific provisions for deduction of the relevant licence and insurance premiums, they were free from the application of the general anti-avoidance provisions. The Court concluded that that position, even at that time, would have been "highly speculative". The Supreme Court observed that the "law had been considerably developed since [*Europa 2*] on which the argument [relied]". The Court concluded that there was nothing in the case law or other tax jurisprudence available in 1998 to support a finding that there was a sufficiently rational basis for the tax position to have had close to a 50% prospect of success.[109]

[175] There is nothing in *Auckland Harbour Board* that would resurrect the possibility that Alesco NZ could properly rely on the *Europa 2* principle to support its claim. I take the same view as did the Supreme Court in *Ben Nevis*, in holding that the tax position actually taken in 2003 was not, viewed objectively, about as likely as not to be correct. It follows that Alesco's tax position was "unacceptable" for the purpose of s 141B and a shortfall penalty is required.[110]

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[109] *Ben Nevis*, at para [201].

[110] Tax Administration Act 1994, s 141B(2) and (4).

*(e) "Abusive tax position"*

[176] Section 141D(1) of the Tax Administration Act requires satisfaction of two conditions precedent to a finding of an "abusive tax position".[111] The first is the existence of an "unacceptable tax position". That criterion is satisfied by my earlier finding. The second is that (viewed objectively) the arrangement was entered into with a dominant purpose of avoiding tax.[112]

[177] Notwithstanding the civil standard of proof applicable, the Supreme Court in *Ben Nevis* held that evidence required to meet the standard should reflect the seriousness of the circumstances of the particular case.[113] It also considered that in assessing whether penalties had been correctly imposed, a court "must give the matter the careful consideration appropriate in a penal context".[114]

[178] On the evidence, it is clear that the purpose of the arrangement was to finance the Biolab and Robinson acquisitions in the most tax effective manner; in other words to secure tax benefits that would reduce the transaction costs otherwise involved. The Notes were artificial, there was no actual interest expense incurred and the option component had no real economic value.[115]

[179] Having regard to my findings on the nature and objective purpose of the arrangement, it necessarily follows that, viewed objectively, Alesco NZ entered into the arrangement with a dominant purpose of avoiding tax. In those circumstances, the tax position taken by Alesco NZ falls within the definition of an "abusive tax position", for the purposes of s 141D.[116]

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[111] Ibid, s 141D(1).
[112] Ibid, s 141D(7)(a) and (b)(ii). See also *Ben Nevis*, at paras [206] and [207].
[113] Ibid, at para [180], citing *Z v Dental Complaints Assessment Committee* [2009] 1 NZLR 1 (SC).
[114] Ibid, citing Shelley Griffith "Tax Penalties" [2008] NZLJ 223.
[115] See para [147] above.
[116] As defined by s 141D(7).

### *(f) Conclusion*

[180] I conclude that the shortfall penalties imposed by the Commissioner meet the statutory criteria. A credit has already been allowed for the taxpayer's prior history of compliance. Therefore, the shortfall penalty assessments stand.

## Result

[181] Each of the challenges to the Commissioner's assessments, in all four of the proceedings, is dismissed. Judgment is entered for the Commissioner on each proceeding. In consequence, the Commissioner's assessments stand.

[182] I did not hear from the parties on questions of costs. The Registrar is directed to convene a telephone conference before me at 9am on the first available date after 27 February 2012 for those issues to be discussed. If costs are agreed or if a timetable to resolve outstanding issues can be put in place by consent, counsel may file a joint memorandum on the basis of which I would make orders, vacate the conference and excuse attendances.

[183] Although, having regard to my findings on the impact of s 138P of the Tax Administration Act 1994[117] it may be unnecessary to do so, I direct that this judgment lie in Court until 1 February 2012, for counsel to consider the issues raised in my Minute of 26 September 2011. While that period is much longer than the 14 days contemplated in my earlier ruling,[118] the proximity of delivery of this judgment to the Christmas vacation makes the extension of time desirable. Counsel may request the Registrar to arrange a telephone conference in early February if there are any issues that arise, on this point, that require judicial direction.

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[117] See para [160] above.
[118] See Minute (No. 8) dated 26 September 2011 at para [4]. I make it clear that the leave granted in para [5] of that Minute remains extant.

[184] I thank all counsel for their considerable assistance.

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P R Heath J

Delivered at 11.30am on 12 December 2011