SPEAKMAN LAW

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Welcome to my end of first quarter (where is the year going?) tax newsletter. Prompted by two high profile captivating cases, read on for more.

Substance v Form: Two Recent cases with Opposite Outcomes

Eric Watson's Cullen Investment case and Frucor's tax avoidance case are profoundly interesting in their own right. Reconciling them is also fascinating. The fact that they each produced opposite outcomes underscores the complexity in whether to prefer the form of a transaction or its economic substance in arriving at tax outcomes. I will discuss how to reconcile the two cases at my next tax seminar (on 10 April), if interested, please contact me for details.

The choice between preferring the form of a transaction or its economic substance is illustrated by the following example. Say I agree to purchase land from you for $1m, for purposes of erecting a warehouse on it, but only on the basis that you supply me materials for the construction of the warehouse at a discount (of, say, $100,000). Is the true cost of the land $1m? Or is it really $900,000? If you prefer the legal form of the transaction then the cost of the land remains $1m. If, on the other hand, you apply economic substance, the true cost is only $900,000.

If you favour the view that the true cost was only $900,000 (because of the correlated $100,000 benefit), how far do you keep looking? Might, in establishing the true cost of the land, you also factor in benefits that the vendor might:

- promise to me by agreeing to supply product for storage at the warehouse; or
- make available to a separate company that I own (either wholly or partly). For example, I may separately have a stake in an earthworks company to which the vendor may provide machinery at discounted rates.

If you do factor in these things in arriving at the true cost of the land, in my example above, at what point do you stop? Do you bring into play all benefits passing from the vendor to me or companies I own? What if my ownership in said company is below 50%? It is the question where one stops in this overall analysis that makes so very difficult the exercise of taxing transactions according to their economic substance.

What's inside

- Substance v Form
- Watson / Cullen case
- Frucor case

Briefly – Special Interest/Law

- Auckland Council saves Eden Park with $63.3m loan/equity package after $7.3m loss for Eden Park in 2018.
- Financial Markets Authority (FMA) spent $4.2m pursuing former Viaduct Capital and Mutual Finance directors, Paul Bublitz, Richard Blackwood, Bruce McKay in court. Each were found guilty.
- Agria (Singapore) and Alan Lai (formerly chairman of PGG Wrightson) facing penalties of over $300,000 for Overseas Investment Act breaches.
- Tax Bill (including short process rulings) passes, becomes law on 1 April.

Briefly – Sport

- Wales demolish Ireland to win six nations, move to No. 2 in rugby standings.
- Poll: Do you think the Crusaders should change their name?
- Rory McIlroy wins players championship; Masters only 3 weeks away.

In the current state of tax avoidance law, transactions are analysed according to the commercial reality of the overall arrangement (which is not the same as, but not altogether different to taxing according to the economic substance of a transaction). Applying this commercial reality test, why was the arrangement in Watson's case found to be tax avoidance and not so in the Frucor case? See below for the answer.

Watson's Refinancing of Cullen Investments is Tax Avoidance

Mr Watson moved from NZ to the UK in 2002. In conjunction with that move, he put in place a series of steps that were designed to distance himself from NZ, including steps relating to his shares in Cullen Investments Limited (Cullen).

These steps were, so he argued, necessary to ensure he was no longer a NZ tax resident (ceasing to be a NZ tax resident admittedly made sense upon his moving to the UK). Those of us with a moderate dose of scepticism might suggest that the truth of his motivation was the reverse; he was concerned, rightly, that upon becoming a non NZ tax resident, interest on his loans to Cullen would attract a 10% withholding tax, which in this case amounted to tax of $59.5m.

So, were the steps that Watson took regarding his shares in Cullen really necessary (but for the tax avoidance I will come onto)? No, they were not.

The steps Mr Watson took were to sell his shares to another NZ company (Cullen Group), for a debt back, to establish companies in the Cayman Islands, to assign the debt owed to him by Cullen Group to the Cayman Island companies and to fund those Cayman Island companies by loans to them. These steps, in aggregate sound complicated but in fact were straight forward. Notably, in distancing himself from ownership of Cullen, Mr Watson substituted himself with a trust settled by his mother and in which he himself was the final beneficiary.

One might well pause here and ask whether these arrangements were effective for Mr Watson to lose NZ tax residence. The transparency of the arrangements puts that in question. In any event, the matter of tax residence has mainly to do with where you spend your time (a day count test) and where you live. It is much less focused on what assets you own. Hence I downplay Mr Watson's arguments that the steps he took were motivated by a desire to lose NZ tax residence.

The result of these steps was that Mr Watson ceased to own shares directly in Cullen and instead:

a. he had loans to the Cayman Island companies for the same value of the shares; and
b. Cullen owed a debt to the Cayman Island companies for that same value.

Here is the rub. By switching what were loans made personally by Mr Watson to Cullen for loans to the "unrelated" Cayman Island companies, there were massive tax savings to be had. Those tax savings were the $51.5m of tax that the court determined Cullen is liable for. These tax savings represent the advantage of a 2% withholding tax rate (actually it is a levy) that applies where an overseas lender is not associated with the borrower, as against a 10% rate where they are associated. As Mr Watson was leaving NZ for the UK, and about to become a UK tax resident, he stood to become exposed to the higher 10% withholding tax. This is what he sought to avoid.

In order to take advantage of the 2% levy, he needed to divest himself of the loans that he had personally made to Cullen. The steps he took, technically achieved that. In substance they did not. His Honour found the tax avoidance threshold had been reached – and he was right to do so. His Honour did so by essentially brushing aside the form of the arrangements (the Cayman Island intermediaries) and instead looking at the commercial reality to establish that Mr Watson remained on the lending side of the loan transaction, just as he was at the outset.

Frucor's Refinancing was not Tax Avoidance

The Frucor case is in many respects similar to the Cullen case. The main similarities were the design to avoid the 10% withholding tax rate on related company loans and steps taken to achieve that, in this case by bringing these loans onshore. In Frucor, this entailed equity arrangements (described below) by which Frucor's ultimate parent in France (Danone SA) replaced its loans to Frucor with a convertible note issued to a NZ party (Deutsche Bank NZ). This avoided a withholding tax liability altogether (unlike the Watson/Cullen case in which the applicable withholding tax rate was reduced from 10% to a 2% levy).

In my view, there was artificiality involved in the way the withholding tax liability was avoided. The artificiality lay in the pre-determined contractual commitments that sheltered Deutsche Bank NZ, as holder of the convertible note issued by Frucor, from any risk attaching to the debt component of the convertible note, coupled with the fact that it did not itself have funds to subscribe for the note. Why arrange to borrow money from a party that you know full well has no means to lend? I do not see that as commercially realistic.

Worse, the contractual arrangements establish plainly that Deutsche Bank NZ was always going to convert the note into shares in Frucor and immediately transfer them to another member of the group, namely Danone Singapore. Deutsche Bank NZ never intended, even for a moment, to obtain for itself an ability to hold an equity position in Frucor (as a convertible note by its nature allows). Nor did the Danone group ever intend for it to have one. The convertible note was merely an instrument designed to achieve the Danone group's wider intentions of overcoming its withholding tax cost. In this respect Deutsche Bank was only ever an agent or facilitator for Danone group's intentions. To my mind this belittles the authenticity of the equity component of the note in the hands of Deutsche Bank NZ.

Yet Justice Muir made a finding of no tax avoidance in the Frucor case. This begs the question, in what way did the Frucor arrangements pass the commercial reality threshold whilst the Watson/Cullen arrangements did not?

In my view, with all due respect to the Judge, the arrangements in Frucor did amount to tax avoidance. Using the example I give at the beginning of this newsletter, His Honour found, in essence, that the true cost of the land was $1m and it was not appropriate to net off the $100,000 correlating benefits.

In the tax avoidance arena, when you look at two transactions (that themselves are very real – in the sense that money flowed under them exactly as stated in the documents), you are faced with the question whether to treat them in isolation on the one hand or to treat them as one, on the other hand. In Frucor, Justice Muir chose to look at the arrangements in isolation from each other. Having done that, His Honour's conclusion that no tax avoidance existed was inevitable. The issue of course is whether His Honour was right to look at the arrangements in isolation from each other.

Let me break down the essential facts and substance of the Frucor arrangement for you. There was a NZ company (Frucor) with debt to its parent in France (Danone SA) of $144m. The interest on that debt attracted expensive withholding tax. The Danone group wanted to improve Frucor's balance sheet. The obvious means of doing that was for Danone SA (in France) to convert some of its debt to equity. In the end result, that is precisely what happened. But it didn't happen in the way you might expect. Conversion of Danone SA's debt to equity was not undertaken directly. Instead it was achieved by:

a. introducing a third party (Deutsche Bank NZ);
b. the issue of a convertible note by Frucor to Deutsche Bank NZ;
c. a forward agreement by Danone Singapore to purchase the shares in Frucor that Deutsche Bank NZ would hold on conversion of the note;
d. payment of the purchase price for those shares from Danone Singapore to Deutsche Bank NZ in advance;
e. application of the money received from Danone Singapore ($149m) by Deutsche Bank NZ in subscribing for the note issued by Frucor (along with $55m obtained by Deutsche Bank NZ elsewhere; as to this part of the financing arrangements there has been no objection or suggestion of tax avoidance);
f. repayment of Frucor's debt of $144m to Danone SA;
g. payment of $60m by Frucor to Danone Singapore on the repurchase of shares that Frucor had issued to it.

As will be evident this is a complicated (and circuitous) means of achieving something (improvement of Frucor's balance sheet) that could have been achieved quite simply. The means by which it was done were, however, highly tax efficient. Notably, amongst these steps was repurchase (and cancellation) of Danone Singapore's shares in Frucor. This poses the question why would Danone Singapore enter into the agreement with Deutsche Bank NZ to acquire shares in Frucor on conversion of the note in circumstances where at the same time it was disposing of shares in Frucor that it already had? To me this smacks of commercial unreality.

Expanding on this, the means by which Danone SA's loans to Frucor were removed first entailed Frucor issuing a convertible note. This might be regarded as unusual given the context, but on its own this is uncontroversial. It issued the note to a third party (in NZ). Again fair enough. It issued the note for enough funds to repay $144m of debt owed to the French parent and return $60m to the Singapore group company upon the share repurchase. Again, this all seems rather vanilla. So where is the issue?

The key issue in my view is that the subscriber to the Note (Deutsche Bank NZ) had no intention to obtain for itself an ability to take an equity position in Frucor. Nor, objectively looked at, did the issuing group ever intend anyone but members of the group to hold the equity in Frucor. Seen in this light, the conversion element of the Note was only ever an instrument designed to achieve the Danone group's aims and not to advantage Deutsche Bank NZ in any way. In reality it was merely a facilitator for the Danone group's aims.

At this point, the issue of the Note begins to look commercially unrealistic. It becomes even more commercially unrealistic when one looks at how Deutsche Bank NZ was funded to acquire the Note. It was funded by the Danone group itself for the large majority of it. This demonstrates the substance of the arrangements being a switching of parent loans into Frucor for NZ based loans, ultimately funded by the same parent but now with the convenience, tax wise, of a NZ lender. All done through circuitous means.

Standing back to look at all this objectively, is it commercially realistic that a company wishing to improve its balance sheet would, in lieu of receiving equity from its parent, instead do so by issuing a convertible note to a party which had no means of its own to subscribe for it. I do not think so.

The Judge has taken a different view. His Honour has evidently:

a. been mindful of the involvement of a genuine third party (Deutsche Bank NZ) in the arrangements;

b. confirmed that the arrangements with Deutsche Bank NZ were genuine and bound it to precise and carefully constructed contractual obligations;

c. established to His Honour's satisfaction that there was no element of compunction involved here, ie the Danone group's influence over Deutsche Bank NZ was limited to the contractual arrangements between them and enforcement of those contracts (unlike related party arrangements where a subsidiary might be required to operate at its parent's direction, thereby introducing the idea of compunction).

Given these elements, the Judge respected the form of the arrangements entered into. His Honour decided that to do otherwise would be to invoke taxation by economic equivalence, which is impermissible.

While I can understand that finding, seemingly heavily (if not wholly) influenced by the third party involvement (that of Deutsche Bank NZ) in the arrangement, I believe there were sufficient elements at play here to allow the Judge to look beyond the economic equivalence prohibition and reach a tax avoidance finding on the basis of a lack of commercial reality.

Reconciling the Watson case with the Frucor case is difficult. The most stark difference between the two is the involvement of a genuine third party in the latter. Time will tell whether the Court of Appeal will overturn the Frucor decision. The case is on appeal. I will update you once the appellate decision is known.

Meanwhile I am sure there is more than meets the eye in the Watson case, with Cullen now saying in the media that they relied on their advisers who were the architects of the scheme. It makes me wonder where might that lead…

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Please feel free to pop in for a visit at Suite B, Level 1,
7 Windsor Street, Parnell.

Contact details

Peter Speakman

Principal

T: +64 9 973 0577

M: 021 854 642

www.speakmanlaw.co.nz