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What is the purpose of a transaction?

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Tuesday, October 6th, 2020

Case law on thepurpose of transactions is starting to develop around the world. Is there a common pattern?

Whether a financing structure was a "tax avoidance arrangement" under now repealed general anti-avoidance provisions of the New Zealand Income Tax Act 2004 was examined last month by the New Zealand Court of Appeal in *Commissioner of Inland Revenur v Frucor Suntory New Zealand Limited* [2020] NZCA 383 .

Deutsche Bank provided a complex, multiparty, multijurisdictional financing structure for to French Groupe Danone SA for the acquisition of a New Zealand company Frucor Beverages Group Ltd (the taxpayer) which was to result in deductions for the New Zealand resident acquisition vehicle, the taxpayer in this case. The deductibility of payments under a five-year convertible note with a face value of $204,421,565 and interest of 6.5 per cent per annum ($66.51 million payable over the term) paid to Deutsche Bank was contested by the parties.

A "tax avoidance arrangement" was defined as one that "has tax avoidance as its purpose or effect, or has tax avoidance as one of its purposes or effects if the purpose or effect is not merely incidental."

The case differs from the other knotty problems associated with GAARs or the PPT, that is, in distinguishing a main purpose from any other purpose and where they may be several main purposes. In this case it was simply the purpose of the arrangements. It is however interesting in showing how the court came to its conclusions. Factual considerations were decisive.

Documentary evidence

A Danon document explained the objectives as follows:

"**What was the point of the scheme?**

The scheme allowed [Frucor] to finance the purchase of Frucor in a way that would entitle it to tax credits for the life of the scheme.

Under the arrangement [Frucor] made two coupon payments to [Deutsche Bank] each year. The coupon payments were approximately $7m per payment and were funded by payment of a fully imputed dividend … to [Frucor]. These coupon payments were treated differently for Management

and Statutory purposes.

For Stat (and Tax) purposes, the whole payment was treated as an interest expense. The interest payment was 100% deductible. Total payments over the life of the scheme added up to $66m, which equated to $21.8m of tax credits (approx $4.4m for each year of the scheme's life).

For Management purposes, part of the payment was treated as an interest expense, and part was treated as repayment of the principal of the convertible note loan."

The taxpayers only witness, a senior tax manager, who was not involved in the transactions suggested reasons for the transaction, apart from the New Zealand tax benefit: cash accumulation/retention benefits, future expanded capital base, Singaporean tax treatment, lower fixed interest rate funding for Frucor, local currency funding and improved debt/equity ratio for Frucor.

The court dismissed foreign tax considerations as a purpose. It considered that the New Zealand tax purpose was not to come at the expense of creating tax problems elsewhere. From an analytical perspective this is simply demoting the foreign tax from being a main purpose to merely incidental (adopting the New Zealand statutory language).

Expert evidence

Expert evidence suggested that the same outcomes would result from simply borrowing the same amount from a bank in New Zealand over the same term at the same interest rate. At the end of the five?year period, Shares could have issued shares to the Singapore company that actually purchased Frucor to fund repayment of the principal.

More decisively however, the court accepted expert evidence that the instrument was a convertible bond or note in name only: the seller was already wholly owned by a company that entered into a legal agreement to own these shares ultimately. The lender had no interest in acquiring shares in the debtor, which were not offered in any case. The lender simply structured a transaction that generated tax benefits for the debtor in return for a fee.

The Bank made no profit from the loan element of the convertible note and had no interest in acquiring non?voting shares in the debtor, which had never declared a dividend. It benefited by its fee of $1.8 million for the design and implementation of the arrangement and enhancing its relationship Danone.

The financing structure was found to be artificial and contrived. It showed that the purpose was to dress up a subscription for equity as an interest only loan to achieve a tax advantage. That is consistent with the sham concept in common law countries. The court said "It is hard to discern any rational commercial explanation for the artificial and contrived features of the arrangement, other than tax avoidance."

EU Abuse of law

A similar approach to the application of the abuse of law doctrine in EU law by the UK First-tier Tribunal, resulted in the conclusion that there was no such abuse in relation to the establishment of a Jersey company by a UK resident to undertake loan-broking services, which were partly subcontracted to the UK resident shareholder of the company in *Newey v Revenue & Customs*

[2020] UKFTT 366 (TC), last month, as well. This followed appeals upto the Court of Appeal and a reference to the Court of Justice of the EU.

The UK tax tribunal reviewed the CJEU and UK court jurisprudence on abuse of law in tax in considerable detail encapsulated in the CJEU formulation that "the effect of the principle that the abuse of rights is prohibited, is to bar wholly artificial arrangements which do not reflect economic reality and are set up with the sole aim of obtaining a tax advantage." Again, analysis of the facts was at the heart of the evaluation.

While contractual terms normally reflect the economic and commercial reality of the transactions and must be taken into consideration, they are not decisive. They may be disregarded or recharacterised if they do not reflect economic and commercial reality, but constitute a wholly artificial arrangement set up with the sole aim of obtaining a tax advantage.

Evaluation of evidence

In determining who made the supplies for VAT purposes, the following facts were relevant:

- Whether the person who makes the supply as a matter of contract was under the overall control of another person?
- Whether the business knowledge, commercial relationship and experience rested with a person other than that which enters into the contract?
- Whether all or most of the decisive elements in the supply were performed by a person other than that which enters onto the contract?
- Whether the commercial risk of financial and reputational loss arising from the supply rested with someone other than that which enters into the contracts?
- Whether the person making the supply, as a matter of contract, sub-contracts decisive elements necessary for such supply to a person controlling that first person and such sub-contracting arrangements lacked certain commercial features?

The tax tribunal found that the Jersey company was not just a brass plate company engaged in rubber stamping or window dressing but actually carried on the properly licenced loan broking business and bore the relevant risks even though functions were outsourced. The UK resident shareholder was not in overall control of the business, which was controlled by the company directors. The commercial reality was that the company did the work and not the UK resident. While the subjective purpose of the UK resident was not canvassed, the purpose of the arrangements emerged from their economic and commercial reality.

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