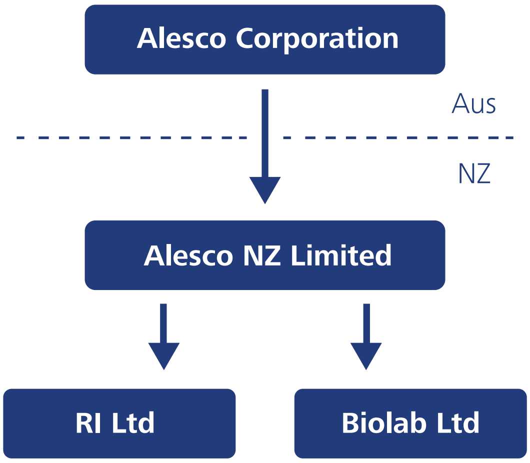
Alesco: The pendulum continues to swing in Inland Revenue's favour

In a judgment released on 5 March 2013 (available **here**), the Court of Appeal has found in favour of the Commissioner of Inland Revenue ("the Commissioner") in *Alesco New Zealand Limited and Ors v CIR*. The central issue was the deductibility of interest claimed under the financial arrangements rules ("FA rules"). This arose from the use of optional convertible notes ("OCNs") in intra-group arrangements to finance the acquisitions of two New Zealand businesses. On the basis of alleged tax avoidance, the Commissioner denied the deductions claimed by Alesco New Zealand Limited ("Alesco NZ") and reduced corresponding loss offsets with other group companies. The Commissioner also assessed Alesco NZ for abusive tax position shortfall penalties amounting to $2.4 million.

Facts and summary of outcome



The facts of the case are not, by themselves, overly complicated. Alesco Corporation ("Alesco"), an Australian incorporated company, wholly owned Alesco NZ. Alesco NZ in turn acquired Robinson Industries Ltd ("RI Ltd") (for $28.653 million) and Biolab Ltd (for $46 million). To finance the acquisitions, Alesco subscribed for OCNs issued by Alesco NZ for an aggregate issue price of $78 million.

It was the use of OCNs to fund the acquisitions that the Court focussed upon. OCNs are hybrid instruments evidencing a debt that the issuer is obliged to settle in cash at maturity or, at the holder's option, the debt may be discharged by an issuance of shares. In this case, the OCNs issued by Alesco NZ to Alesco provided that no interest was payable and, on maturity, Alesco would have the option of converting some (or all) of the OCNs into shares or redeeming the OCNs for cash.

For tax purposes, a convertible note is a financial arrangement having both debt and equity components. The equity component is an excepted financial arrangement, meaning it is not subject to the FA rules. The Commissioner had released Determination G22 as a prescribed method for determining the debt component of an OCN and, therefore, its attributable income or expenditure which is taxable/deductible under the FA rules. By applying Determination G22 to the OCNs, an interest deduction arose for Alesco NZ, even although no interest was paid in cash by Alesco NZ in respect of the OCNs.

The Commissioner acknowledged that the OCNs complied technically with the FA rules, the deductibility provisions and, in particular, Determination G22. The underlying transactions being financed (i.e. the acquisition of RI Ltd and Biolab Ltd) were accepted by the Commissioner as not being entered into for a tax avoidance purpose or effect. However, the Commissioner considered that the OCNs – as intermediate steps in implementing the underlying transactions - were tax avoidance arrangements, so that the interest deductions should be voided under the general anti-avoidance provision.

The Court agreed with the Commissioner concluding that, as Alesco NZ did not incur a legal liability to pay interest or any related economic cost, the use of the FA rules and Determination G22 to claim interest deductions fell outside Parliament's contemplation when enacting those rules.

Our thoughts

Commerciality – choice of funding structure for genuine commercial transaction

Alesco NZ argued that its choice of OCNs had an underlying commercial rationale. The structure was adopted as a mechanism to fund existing financial obligations and this therefore contrasted with other tax avoidance cases, where the transactions in question would not have been entered into but for the tax benefits. That is, "the use of OCNs was an intermediate step along a pre-ordained commercial path".

However, in the Court's eyes, this feature did not protect Alesco NZ. It said "the question is whether the particular arrangement, regardless of whether it was the originating or an intermediate step, had the purpose or effect of tax avoidance".

The Court found that, in legal form and in economic substance, Alesco had made an interest free loan of $78 million to Alesco NZ. Because Alesco already owned 100% of Alesco NZ, the convertible option was of no practical value to Alesco. The alternative of redeeming the OCNs in 10 years' time without any intervening right to interest would result in a significant cost or loss to Alesco. Thus, the Court felt that the decision to use OCNs "cannot possibly have been for a predominantly commercial purpose". That said, the Court did appear to base its decision more squarely on the issue of whether Alesco NZ had incurred genuine economic cost giving rise to the interest deduction claimed (refer paragraph 57 of the judgment).

A couple of observations arise. First, it is essential that every step within an overall arrangement must have a commercial justification. The Court's finding in relation to the use of the OCNs in this structure highlights the need to ensure that there is a commercial reason justifying every step in a transaction - and that contemporaneous documentation clearly sets this out. If any step lacks a clear commercial justification then there is a risk that the Commissioner may seek to use her powers available under the general anti-avoidance rule.

Second, it was not evident that Alesco NZ had investigated alternative funding structures when deciding how to fund the acquisition of RI Ltd and Biolab Ltd. Where taxpayers consider a suite of alternative financing structures, we would suggest that they are entitled to choose the option which is the most tax advantageous, provided that it has the requisite commerciality. This does seem in keeping with comments of the Supreme Court in *Ben Nevis* and *Penny & Hooper*, to the effect that taxpayers should be able to structure transactions to their best advantage.

The counterfactual argument is discounted

Alesco NZ contended that, had the OCNs not been a funding option, it would "almost certainly" have used an interest bearing loan to fund the acquisitions. In that case the loan would have generated a similar (or greater) level of interest deductions in New Zealand (albeit there would also have been a liability for non-resident withholding tax). On this basis, Alesco NZ argued that no tax was really avoided through use of the OCNs. It also illustrated this by reference to a so-called "unbundled" transaction comprising a zero-coupon bond (issued for $38 million, but with a face value of $78 million), together with an option over shares issued for $40 million – which would have given rise to identical interest deductions.

The use of this hypothetical/counterfactual approach was rejected by the Court and is one area where New Zealand differs from Australia in its approach to tax avoidance. What was required to be focussed upon was simply the arrangement actually entered into. It would be interesting to see if the Court's decision in this respect would have been different, had there been clear and contemporaneous evidence of alternative funding structures having been seriously considered by Alesco NZ.

"Dot the i's and cross the t's"

Alesco also offers several lessons on the need to "dot the i's and cross the t's" at every step throughout a transactional process. In this regard, matters that we suggest did not assist Alesco NZ's case were as follows:

- The highlighting of the tax benefits in board minutes and board papers.
- Internal memoranda placing emphasis on the New Zealand tax advantages and the reasons why the Australian anti-avoidance provisions were unlikely to be engaged.
- Footers on advice documents suggesting that the OCNs were a "product".
- Evidence at trial about drivers for the OCN structure was inconsistent with both the tax advisor's correspondence and Alesco's internal memoranda.
- Similarly, evidence at the hearing was not consistent with Alesco NZ's Notice of Response.
- Some of Alesco NZ's evidence was not relevant and was held to have no probative value.

Aspects were described as being "no more than a detailed rationalisation of events that never occurred". This highlights the need to properly document the commercial drivers for steps and an overall transaction at the time.

The Court did emphasise that any tax avoidance enquiry is an objective one, relating to the purpose of the arrangement rather than motives or intentions of the parties. At paragraph 28 of its judgment, the Court confirmed that the enquiry must be confined to the contractual instruments rather than those extrinsic materials. However, it seems inevitable that the Commissioner, and a judge, will be influenced by such materials, which it is clear Crown Law will continue to place before the courts in arguing tax avoidance cases.

As noted in other Tax Alert articles (including in this issue – **Emails: smart ways to manage the potential minefield**), caution must therefore be exercised, to the greatest extent feasible, with emails, board papers and other contemporaneous correspondence. It also highlights the value of being audit ready, and of conducting an "internal discovery" exercise as early as possible in the dispute process so as to expose any potential areas of weakness and to ensure that a coherent, consistent and credible case theory is advanced (again, refer to **Emails: smart ways to manage the potential minefield**).

Commissioner's Power of Reconstruction

The Commissioner voided Alesco NZ's arrangement resulting in the disallowance of its interest deductions and reduction in loss offsets to other group companies. Alesco NZ argued that the Commissioner should have reconstructed and, in doing so, should consider a hypothetical alternative transaction when reconstructing, so as to clearly identify the tax benefit being counteracted. This counterfactual would have been funding the acquisitions through an interest bearing loan from Alesco.

The Court rejected this argument, stating that the Commissioner *may*, but is not required to, have regard to a hypothetical alternative transaction when counteracting any tax advantage obtained from a tax avoidance arrangement. Interestingly, the Court said that forcing the Commissioner to consider the hypothetical alternative in question (giving rise to greater deductions than actually claimed) would enable Alesco NZ to benefit from the consequences of its own "unlawful conduct". The terminology is interesting given that a tax avoidance arrangement does not actually involve any illegality or criminal culpability.

Shortfall Penalties

The Commissioner imposed shortfall penalties for taking an abusive tax position (a penalty of 100% of the tax shortfall), although this was reduced to 50% to take into account Alesco NZ's prior good behaviour. This does appear to be a harsh result.

The statutory provision under which the penalty is imposed requires:

- a taxpayer to have taken a tax position which involves an "unacceptable interpretation of a tax law";
- a tax position that, viewed objectively, is taken by the taxpayer in respect of an arrangement that is entered into with a dominant purpose of avoiding tax; and
- the tax shortfall arising from the taxpayer's tax position to exceed $10,000.

Of particular note is the first of these requirements. A tax position will be an unacceptable interpretation of a tax law if the interpretation fails to meet the standard of being "about as likely as not to be correct".

According to the Inland Revenue's own published guidance and Australian case law that the New Zealand courts have previously had regard to on this issue, this means the position taken need not necessarily be the correct position, or one that has a 50% chance of success. It must however be one capable of being seriously considered by a court. It is difficult to see how Alesco NZ's position did not meet this test, particularly when Determination G22 refers to coupon interest payments which "may be made" - implying it was contemplated that interest may not be paid on notes falling within the scope of the determination.

It is also difficult to reconcile the penalty decision in *Alesco* with other cases in which the penalty was also held to be rightly imposed – such as in the context of the forestry investment structure in *Ben Nevis*.

Conclusion

It is important to bear in mind that Alesco NZ's OCN transactions were entered into 10 years ago, in what was a very different avoidance environment – both in terms of what arrangements were most closely scrutinised by Inland Revenue on audit/investigation, and what approach the courts took in determining general anti-avoidance cases. The pendulum has swung considerably since then.

This highlights that possible litigation on a tax issue could be up to 10 years after a transaction is entered into, and that the current view on avoidance could change over time. This is effectively a crystal ball-gazing exercise without clear guidance from Inland Revenue. Speaking of which, we understand the Inland Revenue's interpretation statement on avoidance, which taxpayers have been waiting on for some years, has now been further delayed until April 2013, no doubt to take the *Alesco* judgement into account.

We do not subscribe to the view that this decision will be a barrier to foreign investment. However, what it does mean is that taxpayers, more than ever, should seriously consider locking in the view of Inland Revenue about transactions by obtaining a binding ruling at the time the transaction is entered into. On black letter law (rather than avoidance) issues, indicative views can also be obtained.

On 4 April 2013, Alesco NZ applied for leave to appeal to the Supreme Court. It will be interesting to see both whether leave is granted and, if so, how the Supreme Court deals with Determination G22 in the context of Parliamentary contemplation and application of the abusive tax position shortfall penalty. Of course it is possible that the prospect of a further Supreme Court general anti-avoidance judgment may further delay release of Inland Revenue's interpretation statement on section BG 1.

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