IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV 2005-404-2843

IN THE MATTER OF	the Tax Administration Act 1994 and the Income Tax Act 1994
BETWEEN	WESTPAC BANKING CORPORATION Plaintiff
AND	THE COMMISSIONER OF INLAND REVENUE Defendant

Hearing: 30 June, 1-3, 6-10, 13-17, 20-23, 27-30 July, 3-6, 10-14 August 2009

Appearances: Jim Farmer QC, Richard Green, Richard Lange, George Cumberland, Charlene Fairnie and Morgan Simes for Plaintiff
Brendan Brown QC, Rebecca Ellis and Alan Goosen for Defendant

Judgment: 7 October 2009

JUDGMENT OF HARRISON J

In accordance with R11.5 I direct that the Registrar endorse this judgment with the delivery time of 4:00 pm on 7 October 2009

SOLICITORS
Simpson Grierson (Auckland) for Plaintiff
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COUNSEL
JA Farmer QC; BWF Brown QC; RA Green

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Introduction

[1] Westpac Banking Corporation has challenged amended assessments issued by the Commissioner of Inland Revenue to its taxation liability for the years 1999 to 2005. The assessments impugn the bank's taxation treatment of nine structured finance transactions entered into with overseas counterparties in that period. The funds invested in each transaction ranged between NZD390m and NZD1.5b. By August 2002 Westpac's total investment in the transactions was NZD4.36b, representing 18% of its assets.

[2] The Commissioner says that the purpose or effect of the transactions or parts of them was tax avoidance. He has reassessed Westpac to liability of $586m. With the addition of use of money interest of $375m, the total amount of tax at issue is $961m (including voluntary payments of $443m made by the bank under protest).

[3] In brief summary, the transactions were structured in this way: Westpac, acting through subsidiaries, purchased preference shares issued by specially formed subsidiaries (in one case a partnership was used) within a counterparty group of companies in the United States and the United Kingdom. Another subsidiary within the group assumed an obligation to repurchase the shares in five years or less. Westpac paid that subsidiary a fee, known as the guarantee procurement fee or GPF, to procure the parent company's guarantee of the subsidiary's obligations.

[4] The counterparty jurisdictions treated the transactions for taxation purposes according to their economic substance as loans. Dividends payable on the shares were thus deductible interest for the issuer. By contrast, New Zealand revenue law treated the dividends according to their legal form as income returned to Westpac on equity investments which was exempt from taxation liability.

[5] This cross-border differential created the first element of taxation asymmetry inherent in the transactions. The parties were able to divide the bank's taxation benefit of exempt income as a component of the dividend rate fixed on the

preference shares. This process, known as tax arbitrage, is a settled feature of international financing arrangements.

[6] Additionally, expenses incurred in the transactions were deductible to Westpac. Principally they were the bank's own borrowing costs and the GPFs. Westpac's right to receive exempt dividends while claiming deductible expenditure created the second or domestic element of taxation asymmetry inherent in the transactions.

[7] The Commissioner makes these allegations: The GPF was an artifice, designed to create a taxation benefit for the parties to share. The mechanism was the dividend rate which was fixed to incorporate both asymmetries and to provide the counterparty with the funds to pay that dividend. By this means the bank was able to offset substantial expenditure against its New Zealand sourced income. And the counterparty received or borrowed large sums at significantly less than market rates. Without this artificial benefit, the financing would never have taken place.

[8] The commercial viability of these transactions, the Commissioner says, depended wholly on the achievability of the deductions which were their goal, and on the existence of certain interdependent prerequisites that drove the structure and detail of the arrangements. In particular, he identifies a New Zealand financial institution with a significant tax capacity; a suitable overseas counterparty with a tolerance for tax driven deals; statutory mechanisms within the New Zealand system which Westpac could use to ensure that the income stream was exempt or relieved from tax and to obtain deductions for tax purposes for the costs; and a statutory mechanism within an overseas tax jurisdiction allowing the counterparty to obtain deductions for the distribution stream.

[9] Westpac carries the statutory burden of proving what is effectively a negative. It contests the Commissioner's assessments. The bank says that it advanced real money to real parties and assumed a real and substantial credit risk; that the business purpose of each transaction was to provide funding to the counterparty group; that the transactions, if viewed with commercial and economic realism, made use of specific taxation provisions in a manner consistent with

Parliament's purpose; and that, contrary to the Commissioner's contention, the transactions were pre-tax positive. The bank denies any element of artificiality, contrivance or lack of business purpose in its use of the specific deduction provisions. It denies also that it shared the benefit of its deductibility entitlement with the counterparty through the dividend rate calculation. And it says that it acted entirely within its legal rights in choosing a structure that used permissible tax advantages.

[10] There is an important subsidiary issue: Westpac says that, if the transactions are found to constitute tax avoidance, the Commissioner's reconstruction of them to counteract the perceived tax advantages is incorrect.

[11] A separate threshold argument has arisen, having major fiscal consequences of its own. The Commissioner alleges that Westpac's deductions for the GPFs under specific provisions were unlawful (his associated allegation of sham was recently abandoned.)

[12] Westpac obtained substantial revenue advantages from these transactions. The bank's dual benefits of exempt income and deductible expenses may seem odd, even unfairly generous. However, a transaction cannot be condemned as having the purpose or effect of tax avoidance simply because the taxpayer favourably structures what was in economic substance a loan in the form of an equity investment.

[13] Conversely, black letter or literal compliance with a specific statutory provision will not immunise the taxpayer against scrutiny under the general anti-avoidance regime. What is required on an avoidance inquiry is a principled identification of the objectionable element or elements of a particular transaction within its statutory context. The inquiry must focus accordingly on whether, by using specific statutory provisions to claim deductions attributable to a transaction, Westpac crossed the line and changed its character from a lawful to an unlawful one entered into with tax avoidance as its purpose or effect.

[14] The Commissioner has cast his net of challenge widely. I agree, however, with Mr Jim Farmer QC for Westpac. The real issue at the heart of the tax avoidance

inquiry is whether it was permissible for the bank to have paid and claimed a deduction for the GPFs: I would add, if not, what are the taxation consequences? Resolution of those and related issues will require a careful factual analysis of the transactions within their statutory context, in accordance with the principles enunciated recently by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 289 and *Glenharrow Holdings Ltd v Commissioner of Inland Revenue* [2009] 2 NZLR 359. As Mr Farmer emphasises, the exercise is to be conducted objectively 'without being distracted by intuitive subjective impressions of the morality of what tax advisors have set up': *Ben Nevis* at [102]. Equally, the result will not be determined by whether one subscribes to a so-called 'commercial' world view or by the opinions of experts, however well qualified.

[15] Also directly relevant is the decision in *BNZ Investments Ltd & Ors v Commissioner of Inland Revenue* HC WN CIV 2004-485-1059 15 July 2009 (the *BNZ Investments (No 2)* case), delivered during the course of this trial. Wild J found that certain structured finance transactions entered into by the Bank of New Zealand had the purpose or effect of avoiding tax. He also upheld the Commissioner's reconstruction of the bank's liability to tax. That judgment will be taken into account but it is not binding and is no substitute for my own independent evaluation of the particular facts affecting Westpac's case. While there are material similarities between the transactions concluded by both banks, there are also material differences, both factually and, apparently, in the way the cases were presented and argued.

[16] Counsel have confirmed that an adverse decision will be challenged. As this judgment is a prelude to the appellate process, I shall attempt to collect all possibly relevant evidence and identify in detail the steps undertaken in the decision-making process. By this means I hope to spare an appellate Court an unrewarding journey through an extraordinarily wide range of material. So, of necessity, much of this judgment will be narrative in nature, especially in setting out the circumstances leading to and affecting the transactions.

[17] In that respect, the length of this judgment is regrettable but unavoidable; even then, it will not do justice to all the careful arguments advanced on both sides. A degree of repetition is also inevitable. A great deal of evidence was called and submissions, both written and oral, were extensive. This depth and intensity was consistent with the stakes at issue.

[18] One other brief introductory comment is appropriate. The evidence highlighted a theme of complexity said to be characteristic of generically described structured finance transactions. The deals themselves involved many legs and money flows. Westpac's structured finance unit proposed the transactions. But the bank had in place a rigorous internal approval procedure and sign-off was required from the chief executive and the heads of finance, tax, legal and credit divisions. Opinions were regularly obtained from external legal and accounting advisors on taxation, securities and regulatory issues.

[19] However, all this must not be allowed to obscure one common denominator; that, when stripped away, the elements of these transactions were no different from any other financing arrangement. The bank advanced funds to third parties, described as an equity investment but subject to an obligation to repay. Arguably the transactions were loans in substance, if not in form. The standard components of pricing, credit and market (currency and interest rate movement) risks were common to all deals. As one Westpac witness observed, 'the Koch transaction [was] very simple at its core'. Structural complexity cannot disguise that essential simplicity, or divert an inquiry away from whether the transactions had the purpose or effect of tax avoidance, and Mr Farmer does not suggest otherwise.

Generic Structured Financing Transaction

[20] I shall now set out in summary form the essential elements of the Koch transaction, which was chronologically the first of the nine (this judgment is concerned only with four of them). Counsel have focused upon Koch on the basis that a finding upon it will be determinative for all transactions. This outline, followed by two descriptive wiring diagrams, will hopefully provide context for the successive introductory stages of this judgment. I shall return later to Koch in much

more detail, when its form and substance will provide the framework for an evaluation of the Commissioner's allegation of tax avoidance.

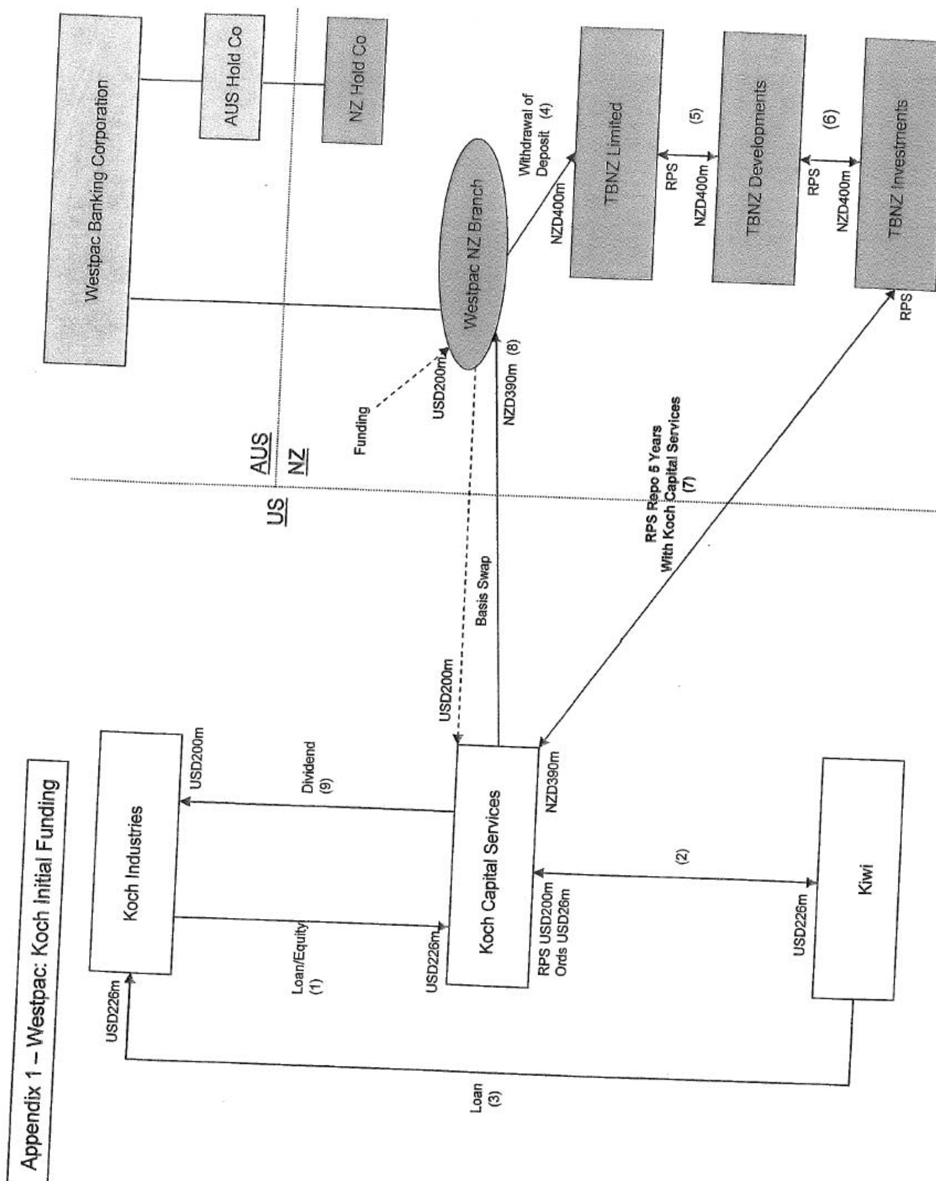
[21] The first step in the Koch transaction was for Koch Industries Inc (KII), the parent entity incorporated in the United States, to capitalise an existing subsidiary (KCS) by a fixed amount. KCS then formed a special purpose vehicle (Kiwi) and subscribed for a small number of voting and a larger number of non-voting preference shares. The latter were denominated in NZD. The holder was entitled to all income distributions or dividends.

[22] Kiwi then loaned directly to Koch an amount equivalent to the amount by which Koch capitalised KCS (and to the total value of the Kiwi shares). In return Koch issued a promissory note for repayment on a fixed date with periodic interest payments sufficient to meet Kiwi's dividend obligations on its preference shares. This note was Kiwi's only asset.

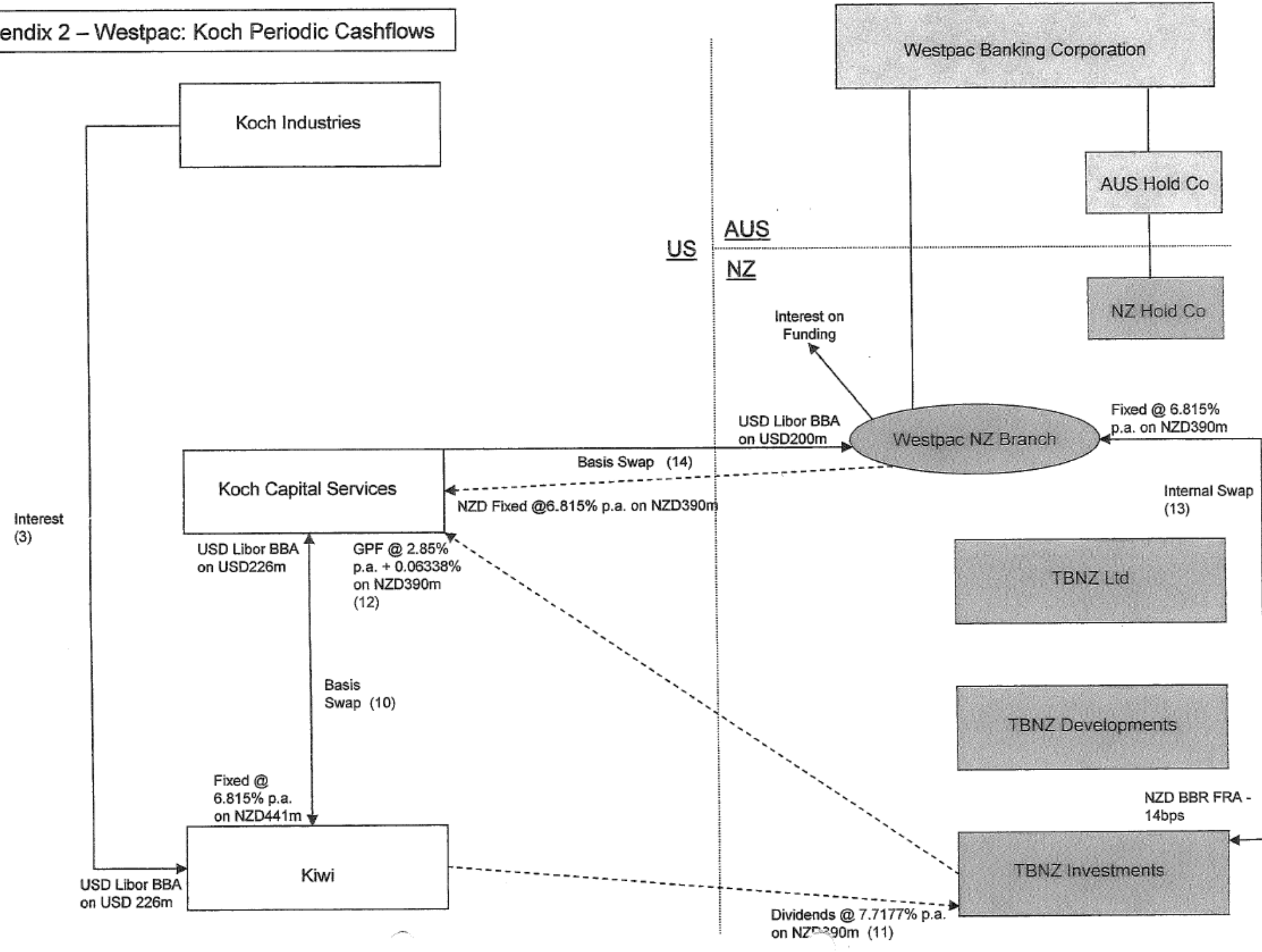
[23] The second step was a transfer or sale agreement whereby Westpac through a subsidiary, Trust Bank New Zealand Investments Ltd (TBNZI), agreed to purchase from KCS all the non-voting Kiwi preference shares for a specified amount. The same parties entered into a separate forward transfer agreement whereby TBNZI agreed to sell and KCS agreed to repurchase the shares for the original price (subject to adjustments) on or before five years, subject to early termination rights. The dividends attaching to the preference shares were payable to TBNZI at a fixed rate on periodic dates. TBNZI agreed to pay to KCS a fee fixed at 2.85%, the GPF, in exchange for procuring Koch's guarantee of performance of KCS's repurchase obligations.

[24] On settlement the parties agreed to swap currencies in the amount of the purchase price (the basis swap). Westpac itself assumed the burden of paying a fixed interest rate on the NZD amount (equivalent to the benchmark rate used to calculate the dividend rate). In return KCS agreed to pay interest to Westpac on the USD amount according to USD LIBOR (London InterBank Ordinary Rate). This was a fixed for floating interest rate swap.

[25] Payments were made at quarterly periods as follows: (1) interest by KII to Kiwi under the promissory note; (2) dividends by Kiwi to TBNZI on the shares; (3) the GPF by TBNZI to KCS; and (4) a net payment on the interest rate swap. The original and periodic funding flows arising from the transaction are recorded on the following diagrams (the entries on Appendix 1 showing the initial Westpac NZ borrowing of USD200m to fund the basis or currency swap with KCS of NZD390m and consequent interest liabilities are in dispute; Westpac denies the Commissioner's assertion that it raised funds at LIBOR or its equivalent to finance the transaction).



Appendix 2 – Westpac: Koch Periodic Cashflows



Summary : Westpac's Case

[26] Westpac is incorporated as a company in Australia. It is registered under the Companies Act 1993 as an overseas company carrying on business in New Zealand. The transactions affect its wholly owned indirect subsidiary, TBNZ Ltd, and TBNZ Ltd's wholly owned subsidiaries including TBNZ Developments Ltd (TBNZD), TBNZ Capital Ltd and TBNZ Equity Ltd. TBNZD's wholly owned subsidiary, TBNZI, is also affected. Westpac has never been tax resident in New Zealand. However, all members of the TBNZ group are tax residents in New Zealand: s OE 2 Income Tax Act 1994 (the ITA) (all subsequent references to statutory provisions are to the ITA unless otherwise stated). Furthermore, each member of the TBNZ group was a 'conduit tax relief company': ss OB 1 and MI 2.

[27] While the name Westpac is used in this judgment as a shorthand for the banking group, 'Westpac group' is not itself a taxpayer. Wholly owned groups of companies do not make joint returns and are not assessed jointly unless they elect to be a consolidated group: Part F, subpart D. All members of the Westpac group took individual tax positions, made individual tax returns and were assessed individually.

[28] Westpac entered into and terminated the nine structured finance transactions at issue with the counterparties as follows:

Name	NZD Amount	Entry	Closure
(1) Koch	$390m	September 1998	August 2000
(2) GE	$189m	May 1999	June 2004
(3) CSFB	$500m	June 1999	August 2001
(4) Rabo 1	$700m	January 2000	July 2002
(5) Rabo 2	$800m	May 2000	July 2002
(6) HSBC	$500m	March 2001	December 2002
(7) BANA 1	$1,000m	September 2001	April 2005
(8) Citibank	$1,500m	June 2002	May 2005
(9) BANA 2	$1,000m	July 2002	May 2005

[29] Westpac issued 33 separate proceedings in this Court between 2004 and 2007. Each proceeding related to the Commissioner's tax treatment of each transaction in each relevant tax year. An order was made that the proceedings relating to the Koch, Rabo 1, Rabo 2 and CSFB transactions be tried together:

Westpac Banking Corporation v Commissioner of Inland Revenue HC AK CIV 2004-404-006444 9 May 2008. Koch, Rabo 1 and Rabo 2 fell for taxation treatment under the conduit tax rules; CSFB was subject to the related foreign tax credit regime. All other proceedings are stayed until further order of the Court, with leave to be granted to proceed only in very limited circumstances.

[30] Westpac pleads that its tax returns for the 2000 income year took appropriate account of Koch. Both TBNZ and TBNZI filed separate returns relating to Koch. Westpac summarised the relevant aspects of its 2000 tax return for Koch, and that filed by TBNZI as follows:

Element of Return	TBNZ Investments	WBC
Guarantee Procurement Fees	(NZD10,946,884)	-
Net Position under Internal Swap	(NZD3,454,699)	NZD3,454,699
Net Income or Net Loss from Internal Swap and Guarantee Procurement Fees	(NZD14,401,583)	NZD3,454,699
Net Loss from above Offset	NZD12,137,788 (to WBC)	(NZD12,137,788) (from TBNZ Investments)
Overall Tax Position in Relation To Internal Swap and Guarantee Procurement Fees	(NZD2,263,795)	(NZD8,683,089)

[31] Mr Farmer submits that the Koch funds were genuinely advanced in a linear (non-circular) manner from Westpac-held deposits to a United States counterparty to be used for its own commercial purposes for a fixed term; that Westpac took real credit risks on the counterparty, the interest rate and the currency; that the interest and currency swaps designed to reduce those risks are commercially commonplace; and that the transaction fell legitimately within the conduit tax regime providing for exemption of foreign company dividends.

[32] Mr Farmer identified seven general propositions relating to Westpac's entry into Koch which he says are inherent in the 'real commercial world'. Thus they bear directly in the bank's favour upon the 'ultimate question' of whether Koch and the other transactions 'viewed in a commercially and economically realistic way' made use of specific ITA provisions in a manner consistent with Parliament's purpose: *Ben Nevis* at [109].

[33] Mr Farmer's seven propositions are that: (1) liability to taxation is a cost for a taxpayer which, like any other cost, it may legitimately minimise within the law; (2) a variety of different funding structures are commonly used by financial institutions, some because the ITA treats them more favourably to the taxpayer; (3) special purpose vehicles are used by companies wishing to isolate liabilities attaching to a particular activity or for other commercial management reasons, and are neither unique nor strange; (4) financiers will be critically concerned to assess credit risks relating to funding recipients and will seek to put in place appropriate security arrangements including guarantees; (5) a direct correlation exists between the degree of risk relating to the recipient and the return expected by the funder – if the return is high with associated high risk, the funder will prudently seek to lay off some risk (undoubtedly at a cost) and a guarantee (for which a fee is commonly charged) is one means of achieving this objective; (6) swaps are a common method of hedging risks associated with forward repurchase obligations and related cashflows which are vulnerable to foreign exchange and interest movements; and (7) taxation benefits available to one party will be taken into account in pricing the transaction, and in that sense will either overtly or implicitly be shared with the other party.

Summary : Commissioner's Case

[34] The Commissioner has calculated the effect of Koch in 2000 differently from Westpac, consistently with his case that the transaction formed part of a tax avoidance arrangement which is void against him for tax purposes. He has summarised the relevant aspects of the tax returns as follows:

Element of Return	TBNZ Investments ($NZ)	WBC ($NZ)	TBNZ ($NZ)
Guarantee Procurement Fees	(10,946,884)	-	-
Net Position under Internal Swap	(3,454,699)	3,454,669	-
Reduced Interest on TBNZ/WBC Deposit (NZD BBR FRA less 14bps)	-	22,721,798	(22,721,798)
Net Position under External Swap and USD Funding (USD LIBOR – NZD Fixed – USD LIBOR)	-	(26,176,497)	-

Net Income or Net Loss from Internal Swap, Guarantee Procurement Fees, Deposit, External Swap or USD Funding	(14,401,583)	-	(22,721,798)
Net Loss from above Offset	12,137,788 (to WBC)	(12,137,788) (from TBNZ Investments)	-
Overall Tax position in relation to Internal Swap, Guarantee Procurement fees, Deposit, External Swap and USD Funding after Loss Offsets	(2,263,795)	(12,137,788)	(22,721,798)

[35] The Commissioner pleads that Koch and the other transactions are ‘arrangements’ for the purposes of ss OB 1 and BG 1 in that each constitutes:

> … a plan or understanding between the Westpac group of companies and the respective [c]ounterparty in respect of the sale and repurchase transaction where the pricing on the distributions from the [c]ounterparty was a function of a formulaic relationship with the sum of the fixed rate leg of the interest rate swap and the guarantee procurement fee, designed to result in the benefit derived from the tax advantages being shared on a pre-determined agreed basis between the Westpac group of companies and the respective [c]ounterparty.

[36] The Commissioner also pleads that the broader arrangements extended to (1) Westpac’s funding of the transactions; and (2) all discussions, decisions and correspondence, internally and externally, as to the transaction structure (including particulars of the entities to be employed) and the implementation steps. (Westpac denies the first element but accepts the second element and that, for the purposes of determining whether it constituted an arrangement, a transaction included all its steps both in New Zealand and in the counterparty jurisdiction.)

[37] The Commissioner pleads:

> 19.4 A more than merely incidental purpose or effect of each of the Koch, GE, CSFB, Rabo 1 and Rabo 2 transactions was to enable the Westpac Group to obtain deductions for income tax purposes relating to the funding cost of the transaction (including the guarantee procurement fee) but to have either no liability or a liability satisfied by foreign tax credit for income

tax on the income arising from it. The tax advantage(s) created thereby were:

19.4.1 shared with the overseas counterparties through the formulaic determination of the income distribution rate which was calculated by multiplying the sum of the fixed leg rate under the swaps and the guarantee procurement fee rate by a fraction such that the combined effect of the three cash flows apportioned the benefit of the tax advantage between the Westpac group of companies and the counterparty group of companies in accordance with the split of benefits negotiated between the parties. The payment of a so-called "guarantee procurement fee" had the effect of augmenting that tax advantage;

19.4.2 regarded by Westpac as a step in the process of Westpac managing and (subject to a self-imposed minimum reported "*effective tax rate*" which placed some limitation on the use of tax shelter, although this restriction was lowered over time and could be avoided by consolidation of foreign tax) optimising Westpac's use of "*tax shelter capacity*" or "*tax shelter consumption*" ["Westpac's tax shelter management process"].

[38] The Commissioner further pleads that:

19.5 Other substantially similar transactions which created similar (but in most cases larger) tax advantages and which were also entered into by Westpac as part of its tax shelter management process were the HSBC, BANA 1, Citibank and BANA 2 transactions ("the other Westpac transactions").

19.6 One significant feature of Westpac's tax shelter management process was the inclusion of terms enabling the size of a transaction to be adjusted or permitting the termination of a transaction at short notice. The substantial purposes of this feature were to allow Westpac to mitigate tax risk and to provide flexibility in the management of Westpac's tax shelter capacity. When the opportunity arose Westpac substituted a prior transaction with a subsequent transaction to achieve a greater return and thus a "*more efficient*" use of the finite tax shelter capacity.

[39] Instances are given of early termination of transactions and entries into replacement transactions including termination of the balance (remaining after the

September 2000 partial unwind) of the Koch transaction in September 2001. The Commissioner says further:

> 19.10 As with the Koch, GE, CSFB, Rabo 1 and Rabo 2 transactions the pricing of the income distributions in the other Westpac transactions and the other Bank transactions was not negotiated on an arm's length commercial basis but was determined by reference to the formula [described above at [35]] and was in each instance designed to achieve the sharing on a pre-determined agreed basis of the benefit derived from the tax advantages generated by the arrangement.

[40] The Commissioner focuses heavily on the existence and quantum of the GPF in each transaction, and pleads:

> 19.13 The more than merely incidental purpose or effect of the provision for and the payment of the 'guarantee procurement fee' in each of the Koch, GE, CSFB, Rabo 1 and Rabo 2 transactions was to increase the deductions claimed in New Zealand by Westpac and the dividend payable to Westpac and therefore the tax advantage under the respective arrangements. The more than merely incidental purpose or effect of the provision for and the payment of the 'guarantee procurement fee' in each of the other Westpac transactions and the other Bank transactions was for an equivalent objective on the part of Westpac or the other New Zealand bank as the case may be.
>
> 19.14 The amount/rate of the 'guarantee procurement fee' payable in each of the Koch, GE, CSFB, Rabo 1 and Rabo 2 transactions was set/agreed without reference by Westpac to the credit status of the forward sale counterparty and not in a manner consistent with arm's length dealings or by reference to any relevant 'market'.
>
> 19.15 Rather, the amount/rate of the 'guarantee procurement fee' in each of the Koch, GE, CSFB, Rabo 1 and Rabo 2 transactions was determined by reference to:
>
> 19.15.1 the extent of the tax advantage sought to be obtained;
>
> 19.15.2 in the case of the Rabo 1 and Rabo 2 transactions, the proportion in which that tax advantage was to be shared with the counterparty (taking into account any decisions that had already been taken as to the pricing of any or all of the other components of the formula);

19.15.3 other bank transactions which contained guarantee procurement fees priced at a similar level notwithstanding that the pricing in those transactions was also arrived at on a pre-determined basis and did not vary according to the credit-worthiness of the guarantor;

19.15.4 a ruling obtained by another bank in relation to a transaction believed by Westpac to be similar to the Koch, GE, CSFB, Rabo 1 and Rabo 2 transactions and retrospectively justified by reference to the First Data ruling, notwithstanding that in both cases the ruling that s BG 1 did not apply to the respective transactions was expressly predicated (inter alia) upon conditions or assumptions to the effect that the guarantee procurement fee was arm's length and was at market.

Evidence

[41] Before dealing with the detail of the transactions and the primary issues, I shall say something about the evidence given at trial.

[42] As noted, the Commissioner alleges that the transactions were arrangements having tax avoidance as their purpose or effect, directly or indirectly, or as one of their purposes or effects being of a not merely incidental nature. An arrangement generally means a contract, plan or understanding 'including all steps and transactions by which it is carried into effect': s OB 1.

[43] As noted also, Westpac accepts that the arrangements encompassed various steps including negotiations and exchanges between the parties, many of which are recorded in contemporaneous written proposals, memoranda, correspondence and emails, leading to the final contracts. Large numbers of documents were produced at trial, occupying a common bundle of 40 volumes. They, together with the formal contractual documents, provide the evidential foundation for determining both the specific deductibility and general avoidance issues.

[44] Westpac led written and viva voce evidence from four employees who were involved in negotiating and implementing the transactions, but not for the purpose of

determining whether or not, for example, Westpac's subjective intention at any time was to avoid taxation liability: see *Glenharrow* at [35]. Their accounts provided a linking narrative, supplementing and explaining the picture available from the primary documents, and were relevant to an assessment of the commercial or economic realities of aspects of the transactions. Subject to certain limited qualifications to be discussed later, oral evidence is otherwise inadmissible to establish that a transaction has a purpose or effect different from that disclosed by the documents themselves: *Tayles v Commissioner of Inland Revenue* [1982] 2 NZLR 726 (CA) at 733.

[45] Both parties called expert witnesses, principally from the United Kingdom and the United States. Westpac engaged 12 experts, and the Commissioner instructed eight. Briefs from two English and two American lawyers and one English banker were read by consent. Two New Zealand academics, Professors Tony Van Zijl and Lewis Evans from Victoria University, and a taxation consultant, Mr Robert McLeod, were also called.

[46] Without exception, the opinion witnesses were truly expert in their fields, their briefs supplemented by oral testimony were articulate and compelling, and the breadth of their knowledge and experience was impressive. However, there is an increasing tendency for parties to resort to experts as advocates for a position, rather than for the proper and permissible purpose of providing impartial opinions within their areas of specialist knowledge, expertise and skill in order to assist the Court in forming its own independent judgment on the facts. The briefs of some experts, particularly those called by the Commissioner, strayed into submission and argument, and were at times conclusory or argumentative on the ultimate issue. The question of whether or not a transaction's purpose or effect is to avoid tax is of a legal nature, and the opinions on it of those expert in other disciplines are not substantially helpful: s 25 Evidence Act 2006.

[47] In my view the areas of specialist knowledge, skill and expertise properly the subject of opinion evidence relevant to these proceedings were: (1) foreign law: UK and USA; (2) banking practice relating to (a) credit analysis and security arrangements, and (b) currency and interest rate swaps; (3) the valuation of the

GPFs; and (4) the economic effect of the transactions. To the extent that witnesses voiced opinions outside these areas, I have disregarded the offending sections of their briefs.

[48] In this regard I respectfully adopt Hammond J's observations in *Commerce Commission v Telecom Corporation of NZ Ltd* [2009] NZCA 338 at [31], upholding Mr Farmer's submission in that appeal:

> … [that] the question for a court in a competition law case such as this is a straight-forward one: whether the impugned firm has used a dominant position in a given market for an anticompetitive purpose. Responding to that question is however difficult. It is an evaluative exercise. Courts have had to work out how to approach that exercise and have utilised economic evidence in the undertaking of that task. But it needs to be kept firmly in mind that an exercise of this kind is still one of a relatively normal character for a court. Whether it be in valuation cases, competition cases, patent cases, or in many other areas of the law, courts have to resort to the assistance of experts, including economic experts. But the law does not thereby become transmogrified into one of trial by experts: it is for the Court, utilising such techniques as it can usefully and appropriately resort to, and on all the evidence which is led, to make the evaluative determination to which we have referred. As with any other case, the expert evidence simply goes into the pool of available evidence to assist the Court on the particular issues it has to resolve.

[49] The tax avoidance dispute will be determined primarily by applying settled legal principles to the relevant facts. Those facts, evidenced by contractual instruments, memoranda, emails and file notes, are not in material dispute. That evidence will provide the primary source of my findings. Nevertheless, in some important areas the opinions of experts will be substantially helpful.

History

(1) Structured Finance Transactions

[50] Mr Ian Gibbs was Westpac's principal employee responsible for the transactions. He was then designated as an associate director in Structured Finance New Zealand, as the business unit was called, and the sole New Zealand member. He is an intelligent, well educated man who holds an undergraduate degree in commerce and a masters degree in taxation studies. He has been employed at

Westpac since 1988, apart from four years with Rabobank starting in 2000. His current title is commercial advisor in Westpac Group Treasury.

[51] Mr Gibbs' evidence spanned a period of activity of nearly three-and-a-half years from early 1997. His written brief exceeded 150 pages. He produced many documents. Mr Gibbs was subject to five days of intensive but unerringly patient and courteous cross-examination by Mr Brendan Brown QC for the Commissioner. He responded in the same commendable spirit.

[52] In conjunction with Ms Julie Osborne, a colleague in Westpac Australia, Mr Gibbs was dedicated to developing a prototype structured finance transaction and to its subsequent implementation with the counterparties. Considerable variations occurred in the time required to develop and negotiate each transaction, ranging from 18 months for CSFB to two months for Rabo 2. Within this period, there were degrees of overlap.

[53] According to Mr Gibbs, structured finance transactions are 'large, complex and highly tailored in nature', in contrast to what he called standardised or 'vanilla' products such as residential mortgages or commercial loan facilities. In his assessment, regardless of the types and objectives, all structured finance transactions are complex, and the participants must understand:

> … many factors including credit risk, tax treatment, accounting treatment, financial and computer modelling, legal issues, banking regulatory treatment, and financial and equity markets products, often across two or more jurisdictions.

[54] Tax arbitrage is, in Mr Gibbs' experience, a common although not exclusive feature of structured finance transactions. Its availability united and underpinned these transactions. Mr Gibbs identified another feature as being 'inherent in the economics of tax effective [or tax arbitrage] transactions'. That was the availability of a tax shelter or tax paying capacity to at least one of the parties, where a transaction's profitability depended on that party's ability to use or absorb the tax benefits available – whether in the form of tax deductions or credits.

(2) Domestic Preference Share Financing

[55] Mr Gibbs' experience with preference share financing, and the type of structured finance transactions which first found expression in Koch, was in the domestic context.

[56] I shall set out in some detail Mr Gibbs' explanation of the tax effects of classic preference share financing. That is because (1) the structured finance transactions, for all their apparent complexity, were built upon similar concepts to those underlying the domestic or 'classic' model; (2) Mr Gibbs' understanding of the taxation benefits of preference share financing was at the heart of his later (and effective) promotion of Koch and the other deals; and (3) Mr Farmer's principal arguments against tax avoidance were aligned closely to the lawfulness of classic preference share financing and the authority of *Commissioner of Inland Revenue v BNZ Investments* [2002] 1 NZLR 450 (CA) (the *BNZ Investments (No 1)* case).

[57] Mr Gibbs understood that preference share financing was a lawful and economic alternative to debt financing when the tax effects of a transaction for the investor and the issuer were not mirrored. He also considered that it was usually insufficient for the investor to benefit from exempt dividends rather than assessable interest, and that it was necessary for a tax or other financial mismatch for the parties as a result of the issuer's right to a deduction for the dividends. Mr Gibbs saw this mismatch as essential for economic preference share financing.

[58] Mr Gibbs produced this tabular example (example 1) of the transaction economics for the issuer and investor in the taxation context:

	Issuer [Borrower]		**Investor [Lender]**	
	Preference shares	*Debt*	*Preference shares*	*Debt*
Income/(cost) before tax	(6.00)%	(7.00)%	6.00%	7.00%
Tax at 33%	1.98%	2.31%	0.00	(2.31)%
Income/(cost) after tax	(4.02)%	(4.69)%	6.00%	4.69%

[59] On Mr Gibbs' calculation in example 1 the investor was in a better position after tax by providing funding to the issuer by preference share financing rather than debt, even though the pre-tax return on the debt was higher. By agreeing to a lower dividend rate instead of an alternative interest rate the investor is able to share the benefit of the tax exempt dividends with the issuer, whose after-tax cost of funds would be 4.02% for preference shares compared to 4.69% for debt. As both interest payable on a loan and dividends would be deductible to the investor, the economics of preference share financing do not depend on the issuer's tax status.

[60] Mr Gibbs identified a similar economic rationale for preference share financing where an issuer would not benefit from tax deductions on a loan, such as where the issuer was a tax exempt entity or had tax losses available. This, Mr Gibbs said, was the typical case of classic preference share financing. He prepared another table, using the same assumptions as in the previous table, to illustrate the economics of preference share financing compared to debt (example 2):

	Issuer [Borrower]		**Investor [Lender]**	
	Preference shares	*Debt*	*Preference shares*	*Debt*
Income/(cost) before tax	(6.00)%	(7.00)%	6.00%	7.00%
Tax at 33%	0.00%	0.00%	0.00	(2.31)%
Income/(cost) after tax	(6.00)%	(7.00)%	6.00%	4.69%

[61] The economics for the investor are the same in both examples 1 and 2. But they differ for the issuer; even so, preference share financing is still less expensive for the investor than debt financing. Example 2 proceeds on the assumption that the dividends are exempt to the investor. However, it applies equally if the dividends carry tax credits, such as New Zealand imputation credits or underlying foreign tax credits. In either case, no net New Zealand tax is payable.

[62] Examples 1 and 2 assume that the investor has available tax shelter through either (1) the investor borrowing to make the preference share investment and having other taxable income against which to deduct the interest cost or (2) the investor not borrowing and consequently not paying tax on the interest that could have been

received if an interest bearing loan had been made instead (this assumption would not be valid if the investor was a tax exempt entity or had tax losses available).

[63] Mr Gibbs confirmed the obvious: that pricing of preference share financing is reflected in a dividend rate attractive to both the issuer and investor. The commonly used foundation is a benchmark interest rate appropriate to the proposed term of the transaction, together with a credit margin, where appropriate, for the issuer. It found expression in this formula:

> Dividend rate = (benchmark interest rate + credit margin) x [1 – (tax rate x 0.5)]

[64] Critically, in this formula the parties would negotiate the factor by which the tax rate was multiplied. Here it reflected equal sharing. But where it was more than 0.5 the issuer would obtain the greater benefit; conversely where it was less than 0.5 it would favour the investor. The dividend formula implied by the examples given above would be:

> 6.00% = 7.00% x [1 – (0.33 x 0.433)]

On this basis, the issuer would receive 43.3% of the benefit and the investor the balance of 56.7%. In Mr Gibbs' experience, investors generally received 45% - 70% of the tax benefits, reflecting the value of tax shelter in their hands.

[65] In Mr Gibbs' view, the dividend formula could be used to derive the net benefits for each party in absolute terms. For the issuer, the benefit is often calculated as the funding cost saving compared to the benchmark interest rate; for the investor, the benefit is usually expressed as the pre-tax equivalent margin above that rate. In both examples the issuer's benefit is 1.00% (7.00% minus 6.00%). As a generalisation, the higher the benchmark interest rate, the greater the benefits for both parties.

[66] In Mr Gibbs' experience, an exempt dividend can be expressed in equivalent pre-tax terms for an investor by dividing or 'grossing it up' by 1 minus the tax rate. Thus the dividend rate of 6.00% would represent a pre-tax equivalent return of

8.96% (6.00%/(1 – 33%)). In economic terms, receiving 8.96% before tax at 33% is the same as 6.00% after tax.

[67] The investor's pre-tax equivalent margin can then be calculated by subtracting from the grossed-up rate the actual, notional or opportunity costs related to the transaction (including funding costs). In examples 1 and 2, assuming the debt rate of 7.00% was the appropriate funding cost measure and there were no other relevant costs, the investor's pre-tax equivalent margin would be 1.96% (8.96% less 7.00%). This margin is economically equivalent to a post-tax margin of 1.31% (1.31%/0.67 = 1.96%).

[68] Mr Gibbs characterised the pre-tax equivalent margin as a 'one-dimensional measure of profitability'. That is because it fails to take account of the credit and other risks involved. To obtain a risk adjusted measure of profitability, an investor may employ a return on equity (ROE) calculation, expressing the margin from a transaction as a percentage of the equity (in place of debt) notionally required to support it – the riskier the transaction, the more equity required.

[69] The ROE calculation essentially divides the annual after-tax profit by the notional amount of bank capital required to support the transaction. The notional capital required is based principally on the perceived creditworthiness of the customer and the committed term of the transaction (credit risk generally increases with term); the amount of notional capital increases as creditworthiness decreases. That notional capital is a small percentage of the tax, less than 2.5%, for a typical corporate customer rate at around A- to AAA.

[70] In Mr Gibbs' experience banks typically aim for a minimum ROE of 16% to 18%. Preference share financing generally produces significantly higher returns because of the income tax effects. Thus, assuming a transaction of NZD100m and a notional capital requirement of 2.00%, the ROE calculation for a bank would be:

> (NZD100m x 1.96% x 0.67)/(NZD100m x 2.0%) = NZD1.313m/NZD2.0m
> = 65.7%

[71] The relevant benchmark interest rate, as noted, usually matches the proposed term and pricing basis of the tax – thus, the five year swap rate would usually be used for a five year fixed rate transaction. Swap rates are used for fixed rate terms of one year or more. By contrast, a bank bill rate (usually a three or six month rate) is used for floating rate instruments. While a five year preference share transaction could be based on a floating rate such as the three month bank bill rate, with the dividend rate reset every three to six months to respond to changes in that rate, this approach is generally undesirable because it leads to fluctuation of the margins for both parties, as shown in this table:

Bank bill (swap) rate	*Dividend rate*	*Pre-tax equivalent rate*	*Investor benefit*	*Issuer benefit*
6.00%	5.143%	7.676%	1.676%	0.857%
7.00%	6.000%	8.955%	1.955%	1.000%
8.00%	6.857%	10.234%	2.234%	1.143%

[72] In this table the investor benefit (the pre-tax equivalent margin) increases as the benchmark rate increases, and reduces as the benchmark rate reduces. The issuer correspondingly gains or suffers a benefit or reduction. Both parties are exposed to the risk of falling interest rates. Protecting one by locking in a fixed benefit would merely accentuate the risk for the other. Accordingly, medium to long term preference share financing transactions usually fix the dividend rate for the term based on an appropriate benchmark interest rate.

(3) AIG Proposal

[73] The subject transactions were Mr Gibbs' first experience of cross-border preference share financing. The initial proposal came through an Australian intermediary, Allco Finance Group, sometime in 1995 or 1996. Allco explained that it had presented a similar proposal to another bank. Mr Gibbs understood that bank to be the Bank of New Zealand. The other bank intended to obtain a binding ruling from the Commissioner before proceeding.

[74] Allco resumed contact with Mr Gibbs in early 1997 after BNZ had successfully obtained a ruling from the Commissioner. It solicited Westpac's

interest in a similar transaction with AIG, a New York based insurer. A proposal was submitted to Westpac in around May 1997. Some of its features were common to Koch and the other later transactions. Materially it provided for a guarantee by AIG of the obligations of the specially formed subsidiary whose preference shares Westpac would purchase. But payment for the guarantee was to be by way of a GPF to an AIG subsidiary. According to Mr Gibbs:

> The AIG guarantee was necessary to mitigate the Westpac group's credit risk under the forward purchase agreement against AIG sub, which was expected to be a special purpose (and therefore uncreditworthy) entity. Although the amount of the fee was not specified in this term sheet, a fax from me dated 5 May 1997 stated "*the guarantee procurement fee discussed to date has been 2.95% p.a.*".

[75] Also of significance was the proposal for a NZD interest rate swap between Westpac and AIG subsidiaries, whereby the Westpac subsidiary would pay fixed NZD and the AIG subsidiary would pay floating NZD. This swap involved notional exchanges of currencies of the principal amount both at commencement and closing dates. Quarterly interest payments would be exchanged by the parties during the term.

[76] Mr Gibbs attributed the interest rate swap proposal to the parties' requirement for a fixed rate exposure on the preference shares which therefore carried a fixed dividend rate (Westpac Group as a whole, however, generally funded itself on a floating rate basis). The swap would also hedge AIG's fixed rate dividend exposure and its floating NZD exposure would more easily be swapped into USD than a fixed NZD exposure. The swap was to be on commercial terms, resulting in an exchange of monetary obligations without affecting the underlying substantive obligations.

[77] Mr Gibbs identified a source of funding within Westpac. TBNZ had earlier sold its banking business to Westpac for cash. As at 30 September 1997 it had retained earnings of about NZD1.4 billion on term deposit with Westpac. He proposed using some of this deposit for the AIG deal.

[78] Mr Gibbs embarked upon negotiations to formalise the AIG proposal. He and Ms Osborne spent three weeks in New York and Chicago in October and

November 1997. Advice was obtained from leading law firms. According to Mr Gibbs:

> Pricing negotiations with AIG were based largely on obtaining as large a share of the net tax benefit from the transaction as possible, based on relevant market custom and in conjunction with other factors such as the transaction size and each party's acceleration rights …

[79] This formula, based on the swap rate and the GPF, was used to derive the dividend rate on the redeemable preference shares:

> Dividend rate =
>
> (swap rate + guarantee procurement fee) * (1 – NZ company tax rate/2.0)

[80] While the GPF proposal was novel, the value of group support would otherwise have been implicitly reflected in a lower dividend rate, Mr Gibbs said. Thus he was:

> … unconcerned by the proposed guarantee procurement fee because I considered it quite legitimate to separate out the value of a guarantee from the dividend rate. The concept of "unbundling" the elements of a financial instrument, such as the interest and principal components of a bond or the dividend and capital elements of a share, was not new to me.

[81] Mr Gibbs was also unconcerned by the prospect of paying a GPF rather than a guarantee fee. He saw the two as commercially equivalent; all other things being equal, the bank would pay the procurer as much as the issuer of the guarantee. He viewed the GPF as consideration for both the guarantee itself and its procurement. Mr Gibbs was also aware that the Commissioner had issued an affirmative ruling on the BNZ transaction which included a GPF. He was not troubled from a taxation perspective, especially given his understanding that, while it would be deductible to Westpac, the fee would be taxable in the US recipient's hands.

[82] A GPF rate of 2.95% was proposed in the initial term sheet prepared for AIG. Mr Gibbs does not recall any discussion or negotiation about it; it was simply 'logical' that in principle the rate was related to the difference in creditworthiness between AIG and its subsidiary. He knew Westpac derived relatively large margins from lending to medium and small businesses (that is, higher risk entities). Thus

2.95% did not strike him as an unreasonable reflection of the credit margin between a low quality (the subsidiary) and very high quality (AAA) entity (the parent).

[83] Two other factors were relevant. One was that to Mr Gibbs' knowledge, Westpac attached little if any weight to mere ownership when evaluating a borrower's credit risk – a company without express parent support was not accorded the credit weighting of its parent by virtue simply of the parent/subsidiary relationship. Also, as BNZ was a large bank comparable in negotiating power to Westpac, Mr Gibbs was influenced by the precedent it set in agreeing to pay a GPF of 2.95% to AIG for a guarantee in a similarly structured transaction.

[84] Westpac required structured finance transactions to follow a formal approval process to ensure compliance with policies and mitigation of exposure to unacceptable risk. The approving entity was called the Structured Finance Committee (the SFC) which had been formed in 1994. The SFC then comprised Westpac's general counsel, head of tax, treasurer and general manager, finance. This body assumed and expanded upon the functions of the former 'Tax Shelter Committee'. Its purpose was to 'ensure that the tax, legal, treasury, accounting, reputational and reporting aspects of the transactions were properly managed, and submissions to the committee were to cover these aspects'.

[85] An important member of the SFC, and Westpac's second principal witness, was Mr Richard Mataira. He was then Westpac's head of NZ group tax. His role was to eliminate the group's exposure to tax risk to the greatest degree possible. As such, he maintained a strong working relationship with the Inland Revenue Department.

[86] The SFC was primarily focused on transactions originated by the structured finance unit. Its transactions were the mechanism through which Westpac minimised its tax exposure. Mr Mataira acknowledged a degree of 'natural tension' with the structured finance unit. Its role was to promote and implement transactions; his role was to ensure that any transaction complied with all relevant tax law requirements and also 'met the high standard of corporate behaviour required by

Westpac Group policies and as determined from time to time by senior executives'. Consideration of 'reputational risk' was always at the forefront of group tax policies.

[87] Mr Mataira was always alert to the risk that any transaction involving net deductions might diminish the level of tax payable for a particular year. He accepted that the structured finance transactions rapidly became the bank's largest consumer of tax capacity. Mr Mataira performed two roles in this respect. One role was to ensure that Westpac always had taxable income in excess of deductions claimed for expenditure in the structured finance transactions, to avoid the prospect of the bank finding itself in a position of excess deductions.

[88] Mr Mataira's other role was to ensure that Westpac maintained its ETR or Effective Tax Rate. The bank's ETR was the ratio of its accounting tax expense to net profit before tax for financial reporting purposes on a group basis; that is, the amount of tax it pays as a percentage of reported pre-tax accounting income, as published in quarterly Reserve Bank general disclosure statements. The ETR was an accounting concept which only related to Westpac's published financial accounts. Significantly, it did not identify the actual amounts of tax paid by the bank in New Zealand and included tax paid in other jurisdictions. In general terms Westpac's annual target was an ETR ranging between 20% and 30%, which it believed was broadly in line with its competitors and other major corporates.

[89] Westpac's internal evaluation process focused on a number of factors, including the transaction's profitability, as measured by its pre-tax equivalent margin and ROE; use of TBNZ's retained earnings to fund the transaction (this prospect restricted the bank's ability to use these funds for capital management purposes); credit risk in the sense of defaults on financial obligations; the quantity of available tax shelter; US tax issues; New Zealand tax issues, including whether a tax ruling was advisable (the principal concern was to ensure the dividends from a special purpose company were exempt from income tax); and the potential impact of the transaction on Westpac's ETR (structured finance transactions often had the effect of reducing the ETR because they reduced the reported tax expense by more than the reduction in profit before tax).

[90] The SFC approved the AIG proposal subject to some changes. Westpac decided to apply to the Commissioner for a binding ruling. Its solicitors, Russell McVeagh, submitted the application on 2 September 1997. The application sought a number of findings regarding the deductibility of the GPF of 2.95%, the non-application of s CN 4 to the fee (a withholding tax regime applying to insurance premia paid to non-resident insurers to which I shall return when considering the threshold deductibility dispute), and the general anti-avoidance section.

[91] On 23 December 1997 the Commissioner issued a favourable draft ruling substantially in the form submitted by Russell McVeagh on 24 November. But about the same time the US Treasury proposed a regulation (Bulletin Notice 98-5) which had the effect of characterising AIG's proposed tax treatment of the transaction as abusive. AIG lost interest and Westpac withdrew its application for a ruling on 15 January 1998.

(4) Koch Proposal

[92] Earlier that year, on 19 March 1997, Babcock and Brown Ltd, an Australian based merchant investment bank, had submitted a proposal to Westpac for a structured finance transaction substantially similar to AIG. The proposal did not, however, identify a particular counterparty. The proposal, Mr Gibbs said, had these principal features:

(1) A Westpac New Zealand subsidiary would acquire all the shares in a New Zealand resident unlimited liability company (NZ Co) established by a US company (US Corp). An unlimited liability company was chosen related to the fact that such companies are 'transparent' for US tax purposes – i.e. treated as a branch of their parent company. As in the AIG transaction, US withholding tax was the reason for a Westpac subsidiary rather than Westpac New Zealand Branch acquiring shares in NZ Co.

(2) NZ Co would receive dividends from a US subsidiary of US Corp for which it would be entitled to deemed underlying foreign tax credits

(UFTCs), and would on-pay dividends to the Westpac subsidiary. The effect of the UFTCs was to make the dividends exempt from foreign dividend withholding payments, and as NZ Co and the Westpac subsidiary would be under common ownership the dividends paid from NZ Co to the Westpac subsidiary would be exempt from New Zealand income tax.

(3) US Corp would hold a call option over the shares in NZ Co, and the Westpac subsidiary would hold a put option over them (exercisable against US Corp). The reasons for these options were the same as for the forward purchase agreement in the AIG transaction, i.e. to characterise the transaction as a loan for US tax purposes (with US tax deductibility for dividend payments to the Westpac investor), while mitigating Westpac's equity risk on the investment in NZ Co.

(4) Westpac New Zealand Branch and US Corp would enter into a USD/NZD currency and interest swap. The rationale for the interest rate component of the swap was the same as for the AIG transaction. The rationale for the currency component was to: (a) convert the NZD share funding into USD funding for US Corp; and (b) hedge the Westpac group's fixed rate NZD exposure on the NZ Co share investment.

[93] Mr Gibbs acknowledged that a floating rate on USD preference shares would have obviated the need for either an interest or currency swap. However, USD as opposed to NZD denominated shares were not advisable for indirect US tax reasons and a floating rate would have created pricing problems for both parties. Babcock did not advise Westpac of any specific reason for the third party's (US Corp's) interest in the funding. However, Mr Gibbs did not regard this as unusual because many companies raise or refinance funding for general working capital purposes.

[94] Babcock presented an amended proposal to Westpac on 26 June 1997. Again it was proposed that the transaction would result in NZ rather than US tax being payable, with the counterparty benefiting from the excess foreign tax credits

available. The proposal did not refer to a guarantee. But an indemnity was available if Westpac did not receive full repayment of its principal on maturity. Alternatively, recourse was directly available by way of the put and call options. The proposal also suggested interest rate and currency swaps to address currency and rate cost issues.

[95] Babcock submitted a further revised proposal on 15 July 1997 and nominated Koch as the counterparty for the first time in September or October. Mr Gibbs first circulated a memorandum to the SFC seeking approval for Koch on 28 November 1997. One of the committee members, Mr Rob Nimmo, Westpac's chief credit officer in Sydney, raised a number of questions on 3 December. Among them was a concern about whether the transaction would be seen publicly as tax avoidance. (Mr Nimmo repeated the same and related concerns on 12 June 1998, among them being the size of the transaction, its 'flimsy' commercial purpose, the risk that the tax issues were 'inconsistent with Westpac's good corporate citizenship', that Koch was not a strategic customer and that Koch's credit analysis was too dependent on rating agencies. Eventually Mr Nimmo approved the transaction, subject to a requirement that Westpac's credit exposure be reduced by provision of a letter of credit from an acceptable bank for 50% of the advance.)

[96] Babcock's proposal languished until early 1998 when Mr Gibbs reconsidered it in the context of the proposed conduit tax relief rules, which were to come into effect on 1 April 1998. Babcock prepared a term sheet in February 1998 involving UFTC relief. There were two material changes. One was the prospect of a KII subsidiary entering into a forward sale agreement of the relevant shares in place of the put and call options. The other was for KII to receive an unquantified guarantee fee from the TBNZ investing entity in consideration of providing a guarantee in its favour.

[97] A GPF, payable to the Koch affiliate rather than KII, was first proposed in March. The change in the nature of the fee was designed in part at least 'to mitigate the perceived risk of a guarantee fee being taxable under s CN 4'.

[98] Westpac and Babcock decided in early April 1998 to pursue a transaction involving conduit rather than UFTC relief. While the two regimes had similar

financial and tax results, the conduit rules enabled the use of fixed rate shares which was desirable for pricing certainty for both parties. Also, Westpac perceived that the conduit regime was sufficiently clear in scope and intent to accommodate the transaction without requiring a tax ruling.

[99] Mr Gibbs identified four differences between Koch and AIG, being: (1) in AIG the interest earned by the issuer on the investment of its share issue proceeds was subject to New Zealand income tax (because it was a New Zealand company owned by AIG) whereas in Koch that income was subject to US tax, meaning there were no New Zealand tax credits available to the Koch group; (2) in AIG the investor obtained New Zealand tax relief for dividends received under the wholly owned subsidiary exemption rather than under the conduit regime as in Koch; (3) Westpac intended to consolidate the issuer in the AIG transaction but not its counterparty in the Koch transaction; and (4) AIG involved only a NZD interest rate swap between the Westpac and AIG groups whereas Koch involved a USD/NZD cross-currency interest rate swap.

[100] Throughout the relevant period Westpac negotiated with Babcock rather than Koch directly. Mr Gibbs described Babcock as ‘an intermediary assisting in the execution and implementation of the transaction’. Later, after contested negotiation, the principals agreed to pay Babcock a fee which was effectively deducted from the gross quarterly payments (a lump sum of 0.495% and 0.135% per annum for four years based on USD200m).

(5) Formal Proposal

[101] Westpac and Babcock had provisionally settled the principal terms by 6 May 1998 when Mr Gibbs recommended to two SFC members, Mr Mataira and Mr John Frechtling, NZ general manager finance, that the transaction should proceed without a tax ruling. Mr Gibbs’ paper sent to the SFC on 18 May provided materially as follows:

> Financing Arrangements
>
> Structured Finance is currently negotiating with Koch Industries Inc ("Koch") in relation to a preference share financing of up to the NZD equivalent of USD 200 million (approximately NZD 400 million) for a term of five years.
>
> Under the arrangements, it is proposed that a wholly owned Westpac New Zealand subsidiary ("Investor") would purchase preference shares issued by a US resident company ("Issuer") controlled by a US subsidiary of Koch ("Koch US"). The transaction would be supported by a guarantee from Koch.
>
> Investor will have an annual right to sell some of the preference shares to Koch US in tranches of say, NZD 75 million. The transaction may not be reduced to below the NZD equivalent of USD 100 million.
>
> Investor will be a newly-formed subsidiary owned by Investor Parent, which will also be a newly formed subsidiary. Investor Parent will be owned by TBNZ Limited ("TBNZ"). Investor will obtain the funds for the transaction from TBNZ, via Investor Parent.
>
> The shares will pay fixed rate dividends quarterly in arrears, in March, June, September and December each year, up to say, December 2003. At the end of that period, the shares will be sold to Koch US at the original purchase price.
>
> Structured Finance Committee approval is now sought to proceed with the transaction as outlined.

[102] The paper also noted that Koch was then the second largest private company by revenue in the United States; it was rated AA+ by Standard & Poors with a Westpac equivalent risk rate of A98. Koch enjoyed strong cashflows and modest financial leverage. It was described as a 'diversified energy group' with a range of financial products and services for its own operations. The group would use the proceeds of the preference shares either to make a loan to a US Koch affiliate or to acquire various debt securities. For US tax purposes, the paper noted, the preference share arrangements were treated as secured loan financing with the dividend cost deductible as interest against other income.

[103] Mr Gibbs' paper also recorded the proposal for Westpac to pay a GPF of 2.85% to the Koch affiliate, and provide a reciprocal guarantee of its subsidiary's obligations under the transaction document. The face value of the investment in the preference shares was the NZD equivalent of USD200m. The dividend rate was not nominated but would provide Westpac 'with the agreed margin of approximately

200 basis points' (2%). The SFC paper described taxation risks and issues as follows:

> <u>Taxation</u>
>
> <u>New Zealand Tax</u>
>
> An opinion in relation to the NZ taxation implications associated with the transaction has been provided by …
>
> Essentially, … advice indicates that once Investor and Investor Parent make the requisite elections there will be no dividend withholding liability on dividends received from Issuer (this result follows from the recent introduction of the Conduit Tax Regime ("CTR") in NZ). The primary reason for this is that the income derived by Investor is non NZ sources (sic) and Investor's ultimate 100% shareholder is Westpac Overseas Holdings Pty Limited, a non resident of NZ.
>
> **Tax losses will arise in Investor due to the dividends from Investor being exempt while the guarantee procurement fee and any net swap losses will be deductible. These losses will be grouped against the Branch's income in consideration for payments equal to 33% of the amount of the losses.**
>
> Appendix 2 shows the indicative losses and payments from the Branch. These will vary over time, depending on the 3 month bank bill rate which affects Investor's net income.
>
> <u>USA Tax</u>
>
> For US tax purposes, the arrangements will be treated as a secured debt financing, given the Forward Sale Agreement and the pledging by Investor of the A Shares. Interest deductions would be available to Koch US for the dividend payments on the A Shares.
>
> Dividend payments to Investor should fall under a general exemption from US withholding tax, unless it can be found that TBNZ, Investor Parent or Investor are a bank, as defined under the US Internal Revenue Code, or TBNZ, Investor Parent or Investor are found to be acting as a "conduit" for a bank. The Tax Representations and Covenants referred to previously are principally aimed at providing Koch with sufficient comfort that TBNZ, Investor Parent or Investor are not acting as a "conduit" under US tax law in relation to its sources of funding for the transaction, its activities, its use of dividend proceeds and other facts.
>
> [Emphasis added]

[104] Mr Gibbs' funding proposal was as follows:

> Treasury
>
> Funding
>
> The funding for the transaction will be provided by TBNZ's cash resources, which comprise principally a deposit with the Branch. TBNZ will subscribe for redeemable shares in Investor Parent, which in turn will subscribe for redeemable preference shares in Investor. Dividends on these shares will be declared periodically, based on the net profits of each company.
>
> Investor and Koch US will enter into an interest rate swap under which Investor will pay the NZD swap rate and receive the NZD Bank Bill Rate. This will convert Investor's fixed rate of return on the A Shares in Issuer into a floating rate of return.
>
> To hedge Koch US's NZD exposure, Koch US and Westpac Treasury will enter into a cross currency swap under which Westpac will pay NZD BKBM and receive USD LIBOR. The swap will be written as a five year swap with an ability to break quarterly without break costs.

The paper noted that the pre-tax margin likely to be derived from the bank's 'consolidated indicative returns' would be 2% per annum, and that allocating 2% equity to the transaction gives a ROE of 68%.

[105] The paper concluded with three discrete financial calculations. The first calculation was of 'Transaction Accounting' as follows:

Assumptions:	
Amount	400,000,000
6 month bill rate	9.00%
Swap rate	8.00%
Guarantee fee	2.85%
Dividend rate	8.59%

	Investor		Investor Parent		TBNZ
	Accounting	*Tax*	*Accounting*	*Tax*	
Dividend income	34,358,000		29,400,000		29,400,000
Fixed swap expense	(32,000,000)		-		-
Floating swap income	36,000,000		-		-
Guarantee fee	(11,400,000)		-		-
NPBT	26,958,000		29,400,000		29,400,000
Taxable income		(7,400,000)			
Tax loss payment	2,442,000				
Tax					
NPAT	29,400,000		29,400,000		29,400,000
Dividends to Parent	(29,400,000)		(29,400,000)		
Retained earnings	-		-		29,400,000

[106] The second calculation was of the transaction's contribution to Westpac's Group Profit & Loss:

Assumptions:	
Amount (NZDm)	400
Dividend rate	8.59%
Swap rate	8.00%
Guarantee procurement fee	2.85%
NZ tax rate	33%

GROUP PROFIT & LOSS (NZDM)	
Dividend Income	34.36
Guarantee procurement fee	(11.40)
Funding cost	(32.00)
Net Income	(9.04)
Tax	14.32
Net profit after tax	5.28
After-tax margin	1.32%
Pretax equivalent margin	*1.97%*

[107] The third calculation was of the Return on Equity Earnings:

ROEE CALCULATION	
Assumptions:	
Allocated costs	100,000
Risk free rate	8.00%
Equity required	2.00%
Net profit after tax	5,280,000
Allocated costs	(100,000)
Capital benefit	640,000
Tax	(178,200)
Adj. net profit after tax	5,641,800
Equity $	8,000,000
ROE	*70.52%*

[108] Mr Mataira was a party to the SFC's conditional approval of the structured finance unit's proposal to enter into Koch on 11 June 1998. He appreciated that the

deal might expose Westpac to tax risks, principally because of uncertainty about the application of technical statutory provisions. Mr Mataira was also concerned with 'the potential application of the general avoidance provision in the [ITA]'. He identified three major tax risk mitigation mechanisms available to the bank – tax opinions, tax indemnity provided by counterparties and tax rulings.

[109] Mr Mataira well understood the elements of the Koch transaction. He believed that they accorded with Westpac group's tax policy; that they complied with all legal requirements; and that they did not 'threaten the [b]ank's reputation as a good corporate citizen'. This state of belief originated in large part from the Commissioner's favourable draft AIG ruling on 23 December 1997. Mr Mataira's main concerns prior to the ruling were whether a GPF was deductible and whether the transaction as a whole or any part of it was tax avoidance. His comfort was not shaken by the adverse US tax regulation which was issued almost simultaneously, and which ended AIG's interest in the proposal.

[110] Mr Mataira met with Mr Gibbs in mid 1998 for the purpose of deciding whether or not to obtain a binding ruling for Koch. In Mr Mataira's view, a ruling was the optimal position for tax mitigation. Mr Gibbs resisted his proposal for commercial reasons (mainly the risk of delays and the commitment of substantial internal resources).

[111] On 22 May Mr Mataira notified Mr Gibbs that he would not seek a ruling provided the structured finance unit obtained a tax opinion from Coopers & Lybrand. That firm advised Westpac on 1 June 1998 of its agreement with an earlier conclusion reached by Simpson Grierson that the conduit tax rules would relieve the bank's dividend return from FDWP; a GPF would be deductible provided it was at a market rate; the EIA rulings would not apply to reduce interest deductions; and the general anti-avoidance provision would not apply.

[112] Mr Mataira imposed a number of conditions on his approval to Koch. One was that the contractual documents include an acknowledgement that the preference share dividend rate was fixed at arm's length. That issue was the subject of ongoing debate with the structured finance unit. But eventually Mr Mataira relented.

(6) Settlement

[113] Mr Gibbs and Ms Osborne spent two weeks in New York in July 1998 settling Koch's terms. All Westpac's negotiations on price took place with Babcock which prepared a detailed pricing model to show the expected cashflows for each party over the term of the transaction. The dividend rate was designed to provide Koch with a net saving below the NZD five year swap rate and Westpac with a pre-tax equivalent margin above it. According to Mr Gibbs:

> Pricing focused largely on producing both an attractive return for Westpac and an attractive cost saving for Koch by negotiating an appropriate share of the available tax benefits for each party, taking into account factors such as the transaction size and each party's acceleration rights.

[114] The parties' intention was that the tax benefits were to be shared equally, according to this formula:

> Dividend rate = [2 x (swap rate + guarantee fee) – swap spread – B&B fees]/(1 + 1/0.67)

Mr Gibbs said that:

> … had there been no guarantee procurement fee, the dividend rate would have been lower (all other things being equal).

[115] Mr Gibbs also said:

> Both the final swap rate of 6.955% p.a. and the swap spread of 0.14% p.a. were arm's length, market rates determined by Westpac Financial Markets. Although neither rate was overtly negotiated, both were able to be readily verified as market rates by Koch, and were subject to Koch's agreement.

[116] The final pricing for Koch was settled by September 1998. Mr Gibbs estimated that it gave Westpac a pre-tax equivalent margin of 1.6%, yielding a ROE for the transaction of 58.15%. He did not regard this yield as exceptional for structured finance transactions as they normally produced higher returns than other business in the bank 'to reflect their complexity, innovation and the sharing of tax benefits where available'.

(7) Rulings

[117] Westpac's senior credit officers remained concerned at the bank's participation in the transactions. There was some momentum to obtain binding rulings. Shortly after the bank entered into Koch, Mr Gibbs faxed Mr Mataira a memorandum relating to the First Data (which I shall discuss shortly) and GE transactions, outlining several arguments against applying for a ruling. Among them were Simpson Grierson's advice that tax risks on the transaction were low; that the Commissioner might alert the US revenue authorities to these types of transactions and promote an adverse legislative response there; that it would be preferable for the Commissioner to come across these transactions in the normal course rather than through the tax ruling process (which Mr Mataira rightly construed as the structured finance unit's concerns about an adverse legislative response); and that there was a risk of delays. Mr Mataira found only the last argument compelling.

[118] However, after entering into First Data, Westpac decided to apply for a ruling. In this respect the Commissioner corresponded at length with Simpson Grierson from early 2000. At about that time Mr John Nash, a senior revenue manager and a member of the IRD corporates section, raised directly with Mr Mataira his opinion that the First Data transaction might amount to tax avoidance. The issue arose again in 2002, after the First Data ruling was issued, and by 2004 Westpac was on notice of the Commissioner's view that the transactions were tax avoidance arrangements.

[119] I will now address each of the four transactions in greater detail, with particular emphasis on Koch.

Koch

[120] I gratefully adopt Westpac's 24-step explanation of the transaction and its use of diagrams to depict each discrete stage.

Step 1 : KII capitalises KCS

[121] Some time before completing the transaction on 16 September 1998, KII subscribed for USD226m (all currency amounts are rounded to the nearest million) new share capital in KCS.

Step 2 : KCS incorporates and capitalises Kiwi

[122] On 10 September 1998 KCS incorporated Kiwi and subscribed for 10 common stock shares with voting rights (common shares) for consideration of USD20m. On 15 September KCS subscribed for the following additional shares in Kiwi: (1) three further common shares for a total consideration of USD6m; and (2) 100 perpetual, non-redeemable preferred stock shares (preferred shares) without voting rights for consideration of USD200m. As a result, the total amount of KCS's capital subscription in Kiwi was USD226m.

[123] The preferred shares carried a right to fixed dividends at the rate of (initially) 7.7177% p.a. on NZD390m (being the liquidation preference amount of the preferred shares and the then NZD equivalent of USD200m). Payments were due quarterly, on 17 March, June, September and December of each year, commencing on 17 December 1998 (distribution dates). This dividend rate was the result of the pricing formula earlier agreed by the parties.

Step 3: Promissory Note

[124] On 15 September Kiwi loaned USD226m to KII. On 16 September KII signed a promissory note for the amount of the loan in favour of Kiwi. The note carried a right to interest at USD-LIBOR-BBA, a floating USD market interest rate. This investment would provide Kiwi sufficient interest income to meet its fixed dividend obligation on the preferred shares.

Step 4 : TBNZ withdraws deposit

[125] On or about 14 September TBNZ withdrew NZD400m previously held on deposit with WBC in a money market deposit account. These funds were retained earnings held by TBNZ.

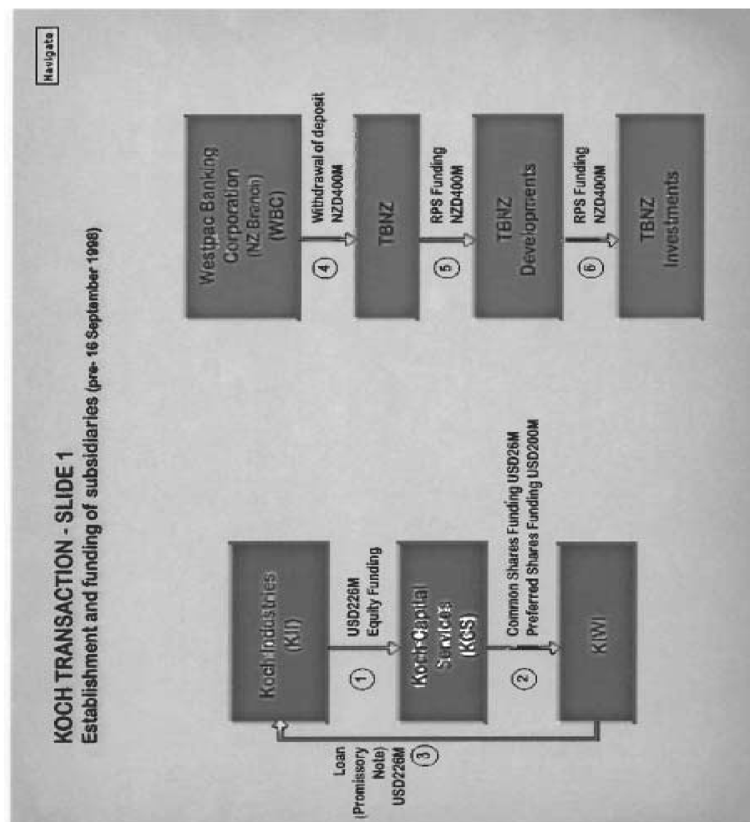
Step 5 : TBNZ subscribes for RPS in TBNZ Developments

[126] On or about 14 September TBNZ subscribed for NZD400m of redeemable preference shares in TBNZ Developments.

Step 6 : TBNZ Developments subscribes for RPS in TBNZI

[127] On 14 September TBNZD subscribed for NZD400m of redeemable preference shares in TBNZI. The involvement of both parties had no tax significance, and simply reflected a corporate structure historically in place.

Diagram 1 – Establishment and Funding of Subsidiaries (pre-16 September 1998)



Step 7 : Transfer Agreement

[128] On 16 September KCS transferred to TBNZI the Kiwi preferred shares for consideration of NZD390m, pursuant to a transfer agreement entered into that day. The NZD10m 'excess' RPS funding (ie. NZD400m less the actual transaction amount of NZD390m) provided to TBNZI (and TBNZD) was returned to TBNZ by way of redemption of NZD10m TBNZI (and TBNZD) redeemable preference shares.

Step 8 : Forward Transfer Agreement

[129] Also on 16 September TBNZI agreed to transfer to KCS, and KCS agreed to receive from TBNZI (in each case based on a total consideration of NZD390m, or a relevant proportion thereof) (the forward transfer agreement):

(1) at TBNZI's option, on any anniversary of the closing date and with at least 30 days' notice, either one quarter or one half of the preferred shares, but no more than one half in aggregate; and/or

(2) on 17 September 2003 all preferred shares in Kiwi not previously transferred to KCS upon partial exercise.

[130] Either party was entitled to terminate early, again with at least 30 days' notice, on the third or fourth anniversary of the closing date, these anniversaries being defined as 'Early Settlement Events'. The forward transfer agreement was central to the sale and repurchase treatment of the transaction for the Koch Group under US tax rules.

Diagram 2 – Purchase by TBNZI of Kiwi Preferred Shares (17 September 1998)

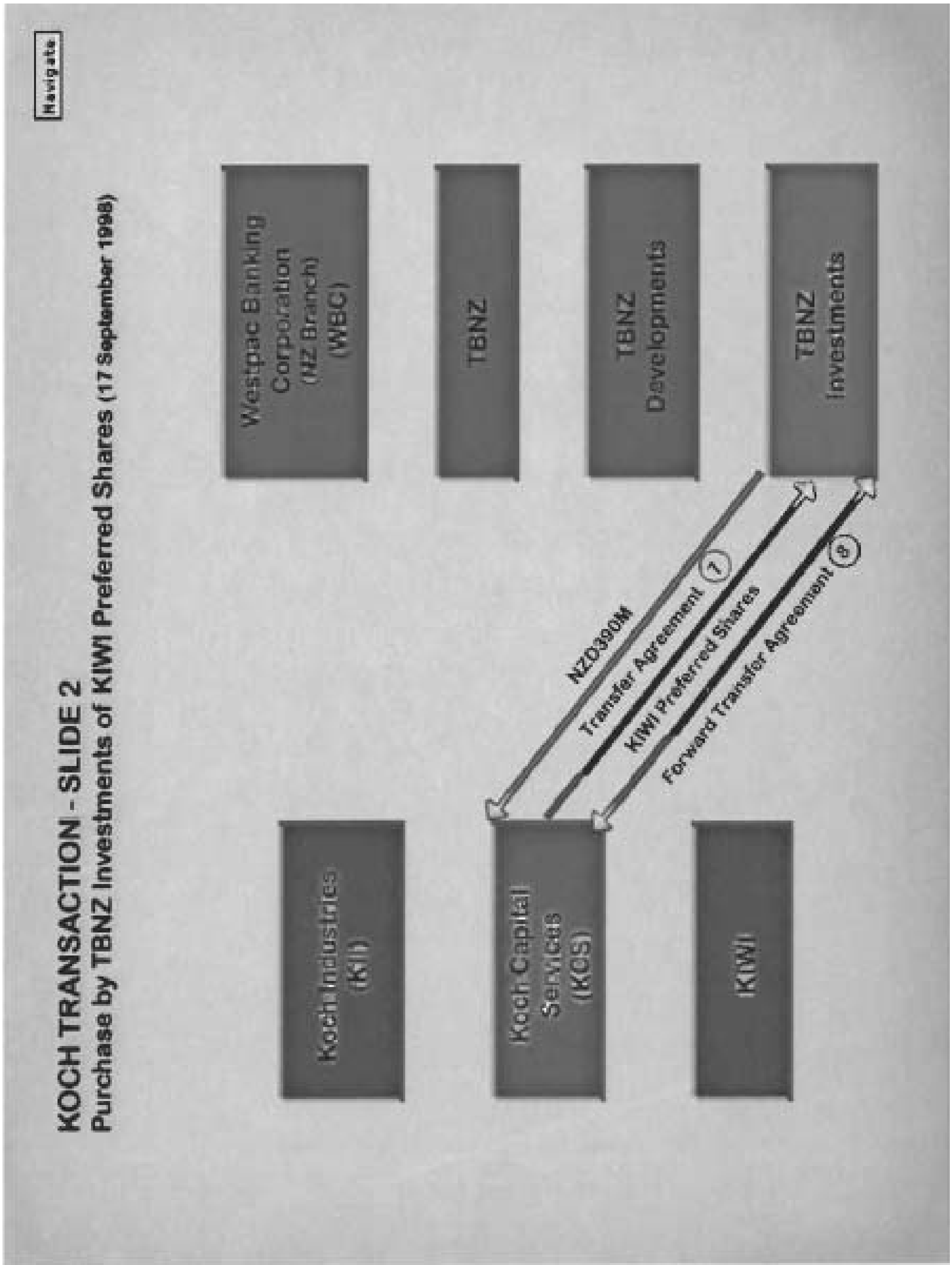
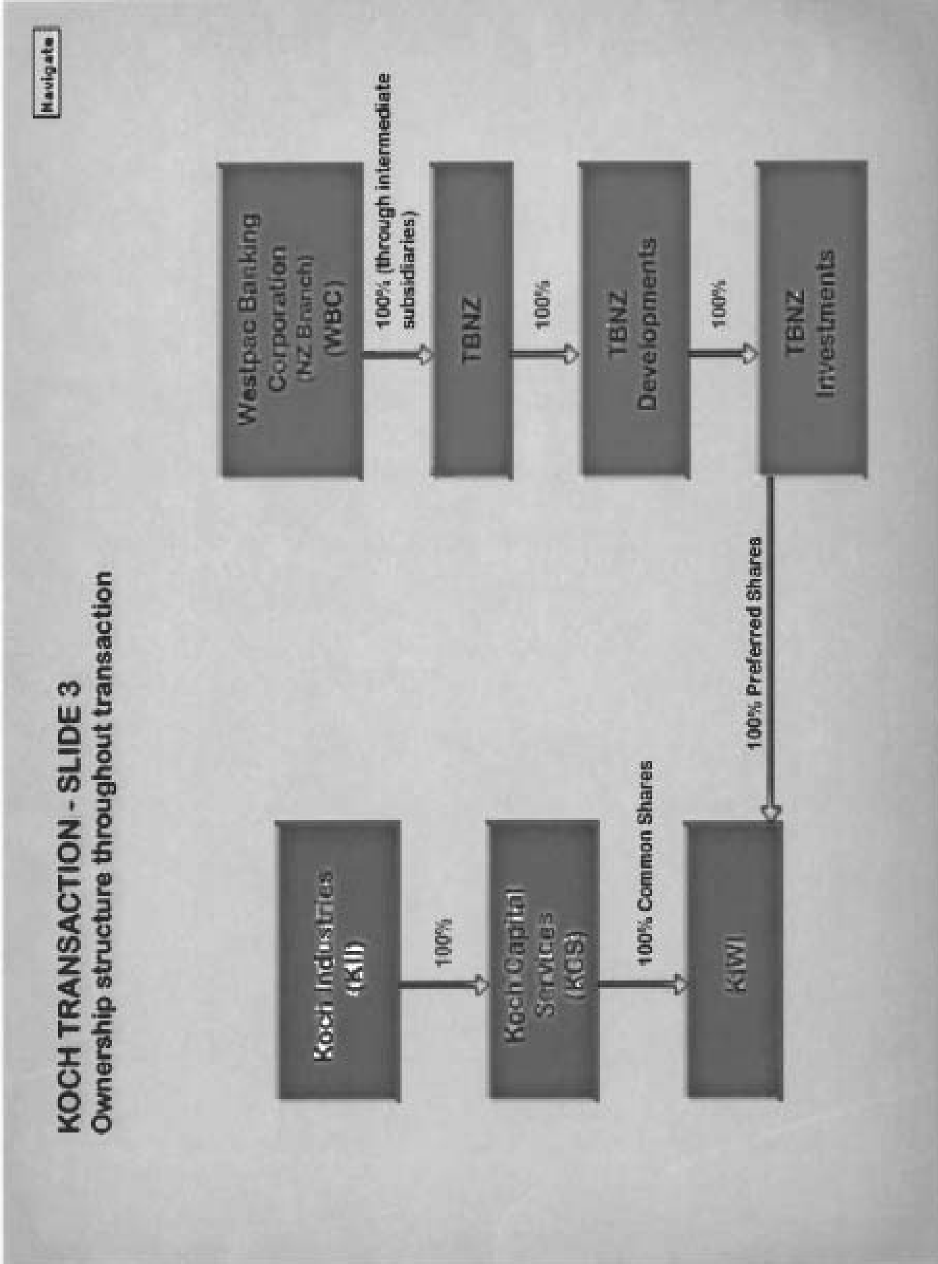


Diagram 3 – Ownership Structure throughout Transaction



Step 9 : Basis Swap between WBC and KCS

[131] On 16 September 1998 WBC and KCS entered into a basis swap whereby KCS agreed to swap the NZD390m it had received for the preferred shares under the transfer agreement into its then USD equivalent (USD200m). This was desirable for KCS because USD is the Koch Group's functional currency. Accordingly, on the closing date, KCS paid NZD390m to WBC and WBC paid USD200m to KCS (the basis swap). The basis swap also provided that:

(1) on the 'Final Exchange Date' (i.e. termination under the forward transfer agreement) there would be reverse flows of principal – i.e. KCS would pay to WBC USD200m and WBC would pay KCS NZD390m;

on distribution dates KCS would pay to WBC floating USD interest of USD-LIBOR-BBA on USD200m and WBC would pay to KCS NZD fixed interest at 6.815% p.a. on NZD390m (6.815% p.a. was the prevailing market NZD five year swap mid-rate (on 14 September) of 6.955% p.a., less a 0.14% 'spread' as explained further in diagram 6, which also shows the resulting periodic cashflows).

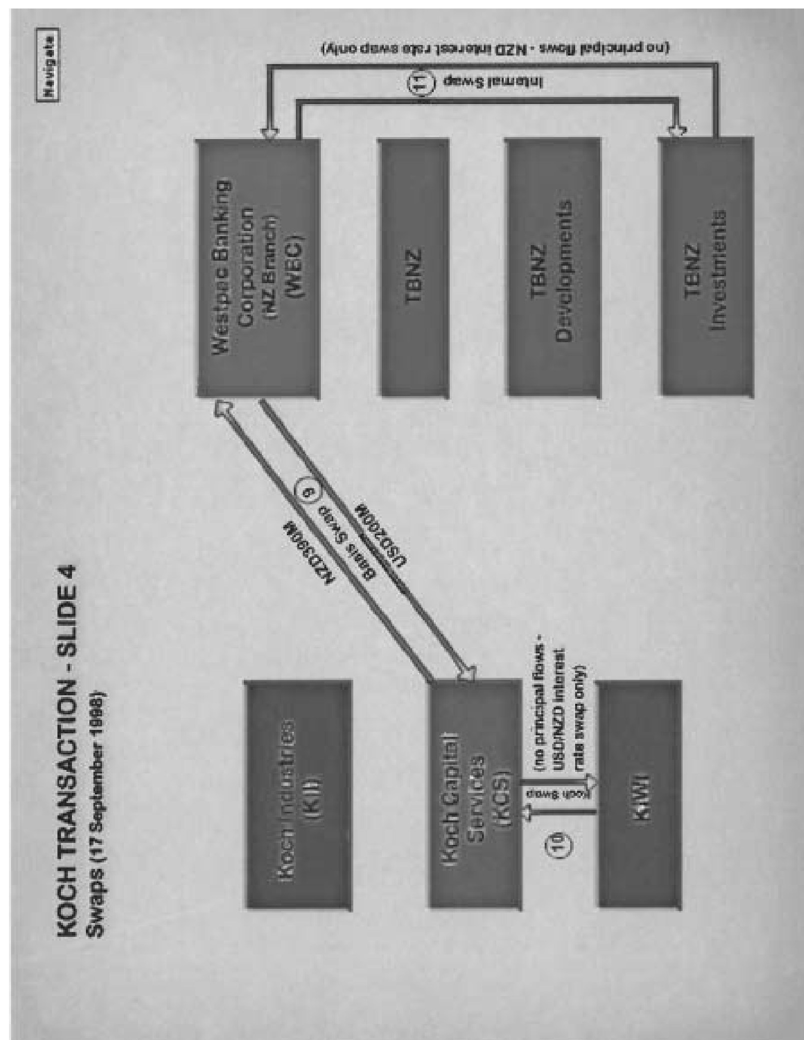
Step 10 : Koch Swap

[132] On 16 September KCS and Kiwi entered into a cross-currency interest rate swap (Koch swap). There were no 'principal' exchanges under this swap, and its purpose was to convert Kiwi's USD floating interest income under the promissory note into a fixed NZD income stream, to meet its NZD preferred share dividend obligation. This is explained further in diagram 6 which also shows the resulting periodic cashflows.

Step 11 : Internal Swap

[133] Also on 16 September TBNZI and WBC entered into a NZD interest rate swap (internal swap). As with the Koch Swap, there were no 'principal' exchanges under this swap. Its purpose was to hedge TBNZI's fixed rate (Kiwi dividend income) exposure. This is also explained further in diagram 6 along with the resulting periodic cashflows.

Diagram 4 – Swaps



Step 12 : GPF Agreement

[134] On 16 September TBNZI and KCS entered into a guarantee procurement fee agreement under which:

(1) KCS agreed to procure a guarantee from KII (KII Guarantee) in favour of WBC, TBNZI and their affiliates of KCS's obligations under (*inter alia*) the forward transfer agreement and the basis swap; and

(2) TBNZI agreed to pay to KCS on distribution dates a guarantee procurement fee, in consideration for KCS procuring the KII Guarantee from KII, at the rate of 2.85% p.a. on NZD390m. Again the resulting periodic cashflow is shown on diagram 6.

Step 13 : KII Guarantee

[135] On 16 September KCS procured the KII Guarantee from KII.

Step 14 : Toronto-Dominion Letter of Credit

[136] On 16 September KCS obtained a one-year irrevocable standby letter of credit of NZD195m (being half of the amount required to be paid pursuant to the forward transfer agreement) from the Toronto-Dominion Bank, in favour of TBNZI, in partial support of KII's obligations under the KII Guarantee. TBNZI agreed to compensate KCS for half of the fees payable by KCS to Toronto-Dominion in consideration of the letter of credit. The total letter of credit fee was 0.25% p.a. of NZD195m, so TBNZI compensated KCS for 0.125% p.a. of NZD195m. The letter of credit lapsed on 16 September 1999 and was not replaced.

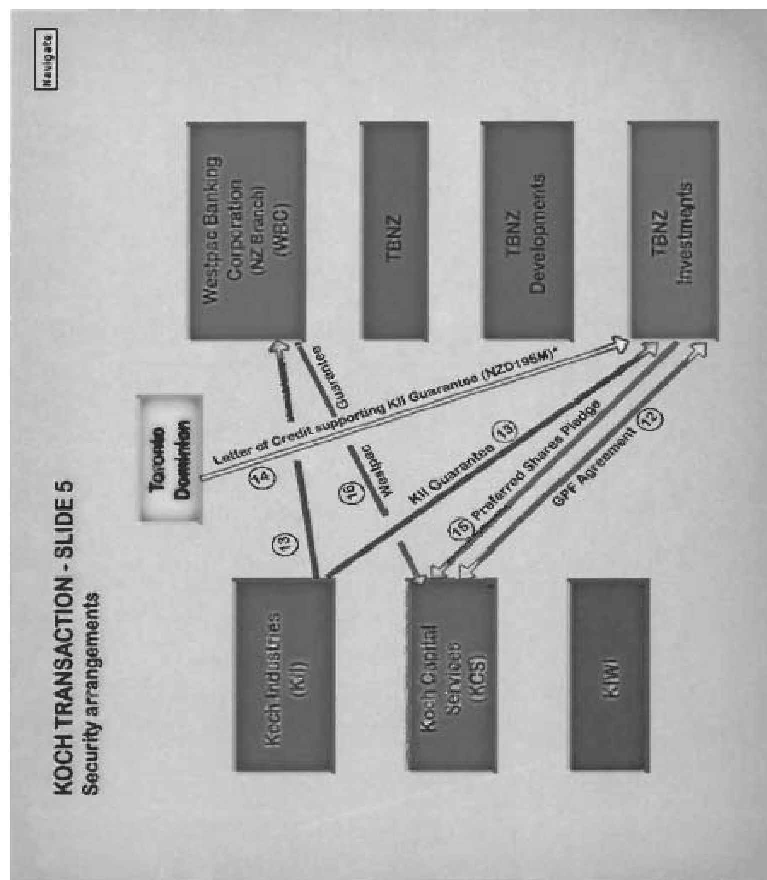
Step 15 : Preferred Shares Pledge

[137] On 16 September TBNZI and KCS entered into a pledge agreement, under which TBNZI granted KCS a security interest in the Kiwi preferred shares. This was security for TBNZI's obligation to transfer the preferred shares to KCS under the forward transfer agreement.

Step 16 : WBC Guarantee

[138] On 16 September WBC executed a guarantee (WBC Guarantee) in favour of KCS (as well as KII and Kiwi) for TBNZI's obligations under (*inter alia*) the forward transfer agreement and the guarantee procurement fee agreement. KCS did not pay a fee for it.

Diagram 5 – Security Arrangements



Step 17 : Promissory Note Interest

[139] On each distribution date KII paid interest in arrears to Kiwi at USD-LIBOR-BBA on USD226m pursuant to the promissory note.

Step 18 : Koch Swap

[140] Pursuant to the Koch Swap, on each distribution date Kiwi paid to KCS USD-LIBOR-BBA on a notional principal amount of USD226m. In exchange KCS paid to Kiwi NZD fixed interest of 6.815% p.a. on a notional principal amount of NZD441m (being the NZD equivalent of USD226m when the Koch Swap was entered into). In this way, Kiwi swapped out of the USD-LIBOR-BBA it received from KII under the promissory note into NZD fixed of 6.8150% p.a. on NZD441m. As noted, Kiwi needed the fixed NZD payments received under the Koch Swap to pay the NZD dividends on the preferred shares to TBNZI, at the prescribed dividend rate of (initially) 7.7177% on NZD390m (6.815% p.a. on NZD441m was approximately equal to 7.7177% p.a. on NZD390m (NZD30m p.a. or NZD 7.5m on each distribution date)).

Step 19 : Kiwi Dividend

[141] On each distribution date Kiwi paid a NZD dividend to TBNZI of 7.7177% p.a. (for the period 17 September 1998 to 16 September 1999), 7.9177% p.a. (for the period 17 September 1999 to 17 September 2000) and 7.7177% p.a. (for the period 18 September 2000 to 17 September 2001) on NZD390m (i.e. the face value of the preferred shares). The two rate changes were made pursuant to an amendment agreement entered into on 17 August 1999. Koch agreed to the 0.20% increase (to 7.9177% p.a.) from 17 September 1999 in consideration of Westpac agreeing not to exercise its right to terminate 50% of the transaction with effect from that date. However, the parties also agreed to reduce the dividend rate by 0.20% (i.e. back to 7.7177% p.a.) should Westpac subsequently exercise that right, which did occur with effect from 17 September 2000. The dividend rate change to 7.9177% increased the required quarterly payments from NZD7.5m to NZD7.7m.

Step 20 : Internal Swap

[142] On each distribution date TBNZI made a NZD fixed rate payment to WBC of 6.815% p.a. and WBC made a NZD floating rate payment to TBNZI of NZD-BBR-FRA (less 14 basis points) pursuant to the internal swap, on the notional principal amount of NZD390m. This swap hedged TBNZI's fixed rate (Kiwi dividend income) exposure. The fixed rate payments by TBNZI equated to the amount required by WBC to make the NZD fixed rate payments to KCS under the basis swap.

Step 21 : Basis Swap

[143] On each distribution date WBC made a NZD fixed rate payment to KCS of 6.815% p.a. on NZD390m and KCS made a USD floating rate payment to WBC of USD-LIBOR-BBA on USD200m pursuant to the basis swap. These swap payments hedged WBC's fixed rate exposure under the internal swap. The NZD fixed swap rate of 6.815% p.a. used in the basis swap (and the internal and Koch Swaps) was the prevailing market NZD 5 year swap mid-rate (on 14 September 1998) of 6.955% p.a., less a 0.14% 'spread' which was deducted to compensate WBC for the cost of hedging the mismatch in its net exposures to NZD-BBR-FRA (under the internal swap) and USD-LIBOR-BBA (under the basis swap).

Step 22 : Guarantee Procurement Fee

[144] On each distribution date TBNZI paid to KCS:

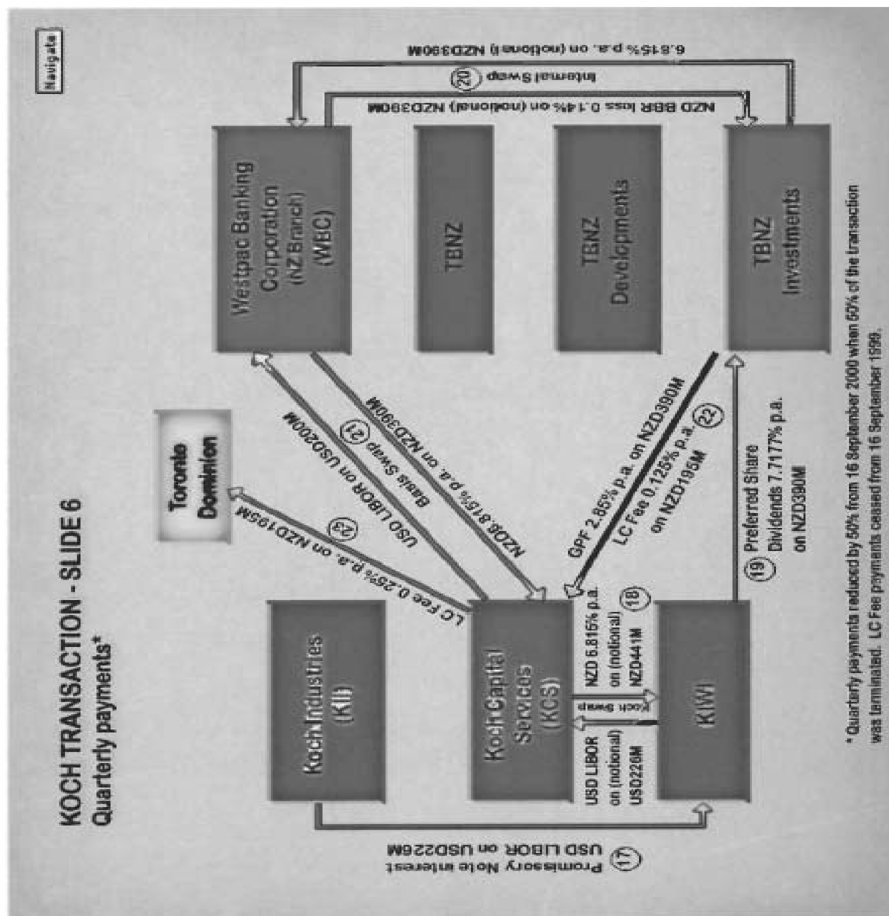
(1) a GPF of 2.85% p.a. calculated on NZD390m pursuant to the guarantee procurement fee agreement; and

(2) the letter of credit fee contribution of 0.125% p.a. on NZD195m.

Step 23 : KCS Letter of Credit Fee

[145] On each distribution date KCS paid to Toronto-Dominion Bank the letter of credit fee of 0.25% p.a. on NZD195m. Also KCS, Kiwi and TBNZI entered into an escrow agreement under which KCS was appointed as an escrow agent of Kiwi's preferred shares dividend payments to TBNZI and TBNZI's GPF payments and letter of credit fee contributions to KCS. KCS would receive all payments in its escrow agent capacity and release them to the relevant recipient provided the recipient had honoured its own payment obligations. The escrow agreement did not involve any set-off arrangements.

Diagram 6 – Quarterly Payments



Step 24 : Partial and Final Termination

[146] One half of the Koch transaction was terminated on 17 September 2000 following TBNZI's partial termination notice. To effect partial termination: (1) TBNZI transferred 50% of the preferred shares to KCS; (2) KCS paid to TBNZI a partial forward transfer price of NZD195m; and (3) the basis swap and internal swap were terminated in part and adjusted accordingly. In addition, the amount by reference to which the GPF was calculated under the GPF agreement was reduced to NZD195m.

[147] The balance of the transaction was terminated following an early settlement event notice by TBNZI on 17 September 2001. To effect termination: (1) TBNZI transferred all remaining preferred shares to KCS; (2) KCS paid to TBNZI a partial forward transfer price of NZD195m; (3) a final principal exchange was effected under the basis swap which was terminated; and (4) all other agreements were cancelled.

Diagram 7 – Termination

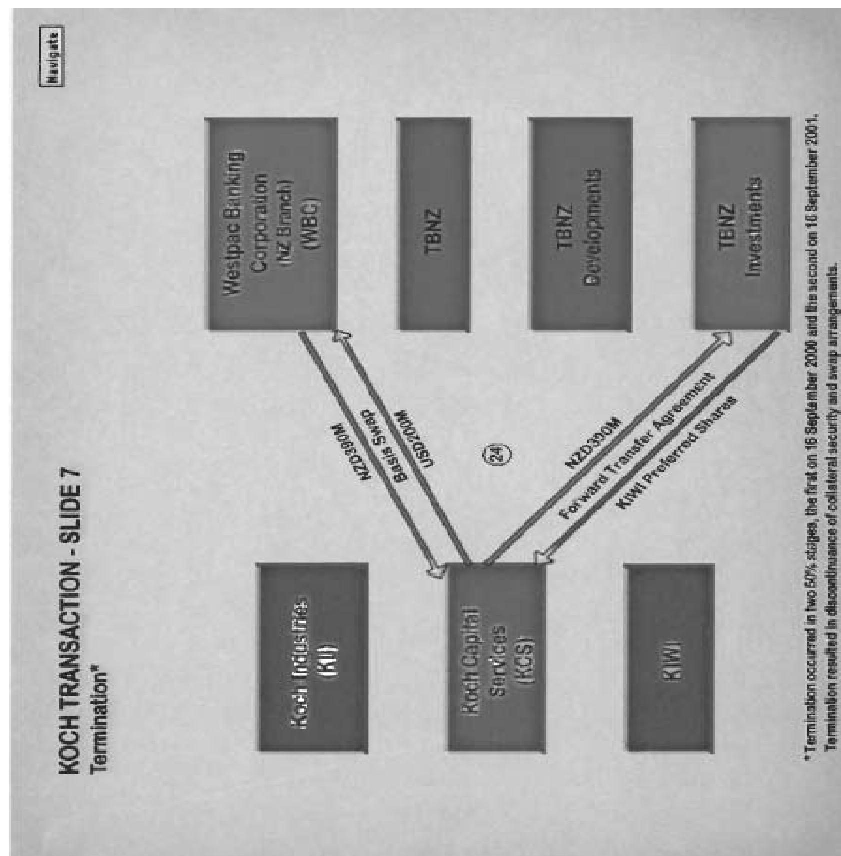
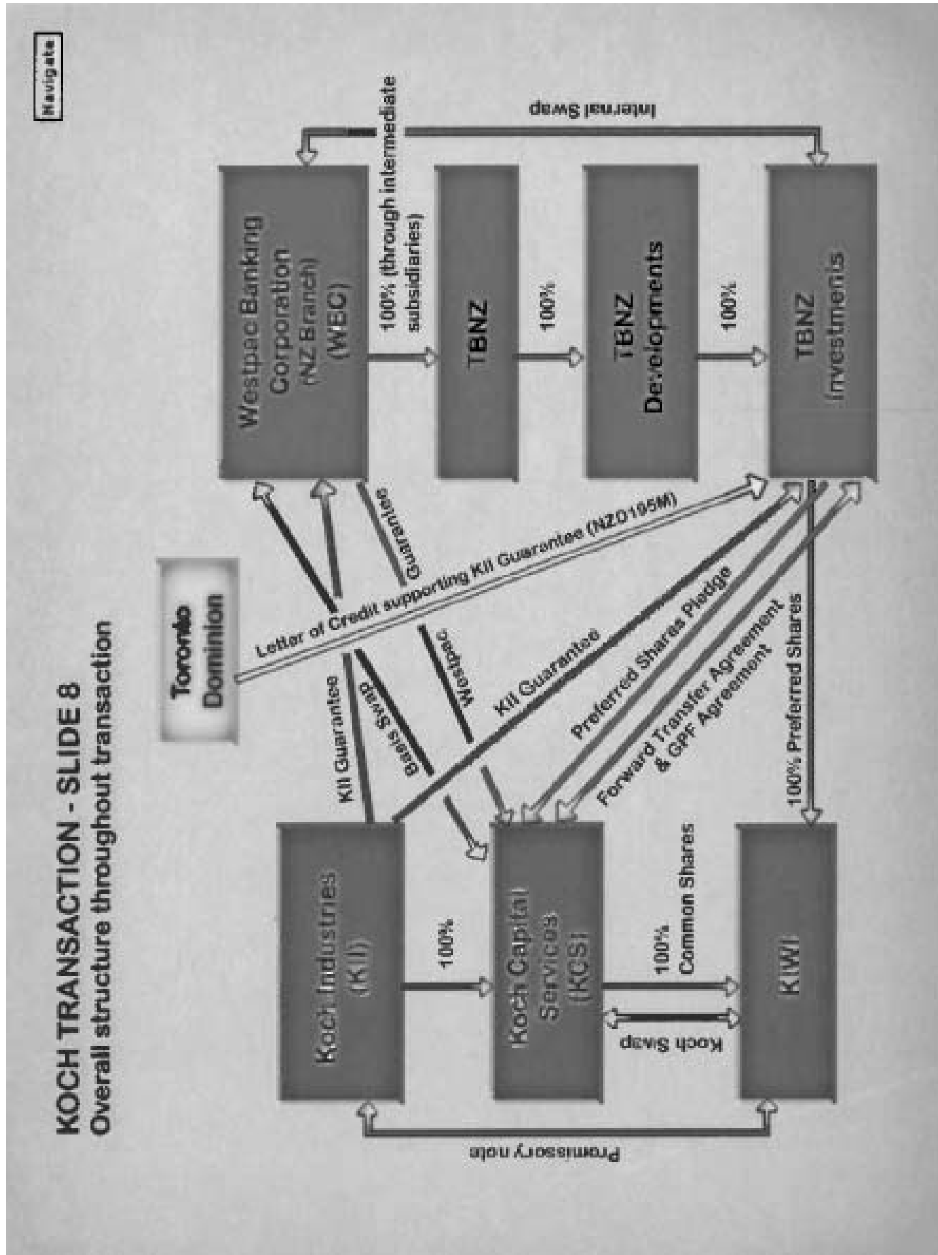
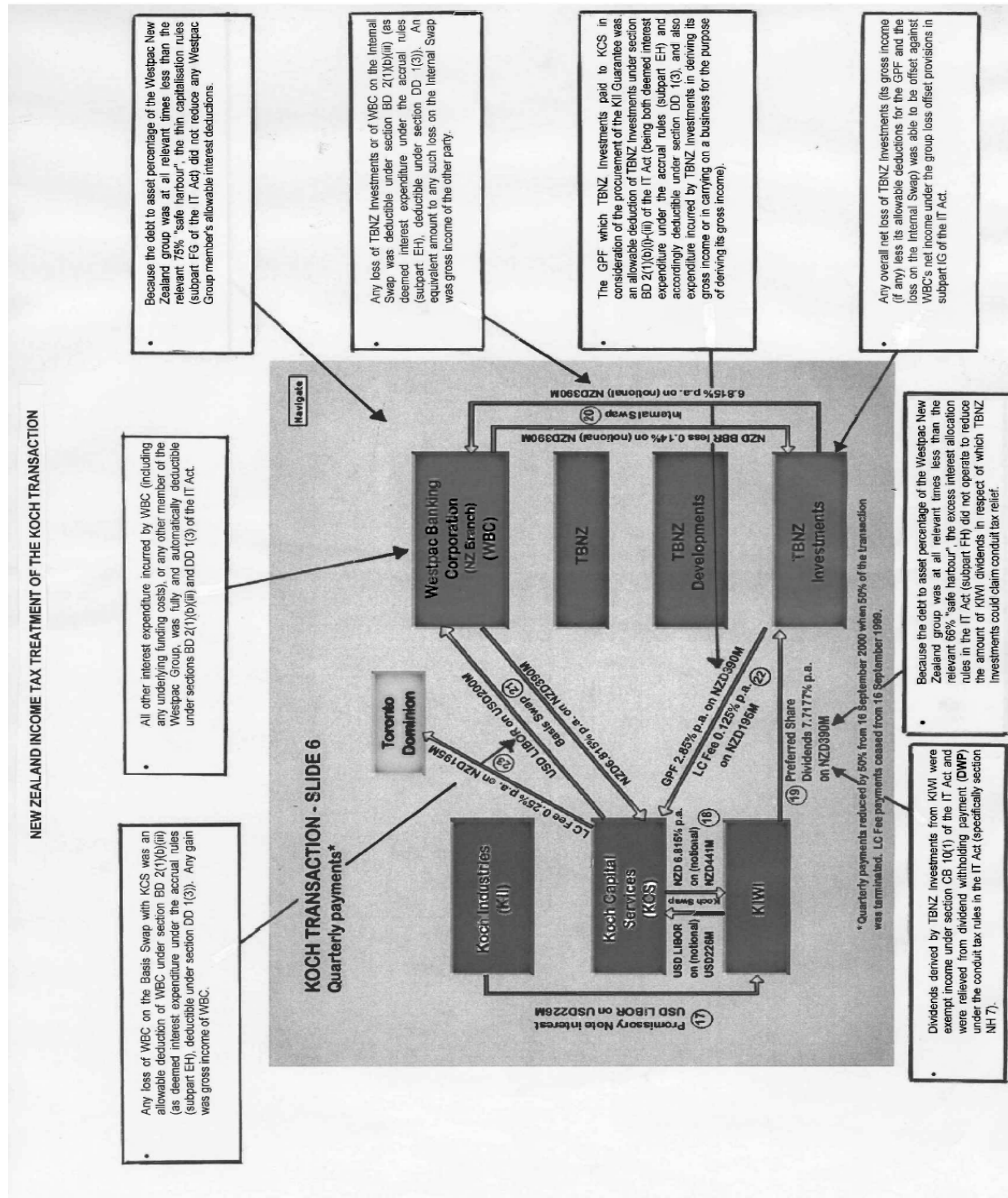


Diagram 8 – Overall Structure throughout Transaction



Koch : Tax Steps

[148] Westpac's treatment of the tax features of Koch are as follows:



CSFB

[149] Westpac entered into the CSFB transaction on 9 July 1999. Its material features were as follows:

(1) Madison Park Partnership (the Partnership) was established with NZD500m of Class A Interests and NZD462m of B Partnership Interests allocated to MadPar Corporation (MadPar), and NZD1,000 of C Partnership Interests allocated to Park Square LLC.

(2) The Partnership loaned NZD962m to CSFB by way of a promissory note bearing interest at a rate sufficient to provide the partnership with the level of income necessary to meet its agreed level of distributions.

(3) TBNZ Equity Ltd (TBNZE) purchased the A Partnership Interests from MadPar for AUD395m, subject to a forward repurchase agreement at the same price. (The denomination of these prices in AUD had been requested by Westpac for Australian tax reasons).

(4) TBNZE concurrently sold the A Partnership Interest to TBNZ Investments (UK) Ltd (TBNZ (UK)) for AUD395m, subject to a forward repurchase agreement at the same price.

(5) TBNZE entered into a NZD/AUD currency swap with MadPar, and to hedge its position, an equal but opposite such swap with TBNZ (UK).

(6) The A Partnership interests were entitled to 99.5% of the Partnership's post US tax profits.

(7) MadPar agreed to provide a minimum return of 7.8033% p.a. on the face value (AUD395m or NZD500m) of the A Partnership Interests and warranted that the Partnership would pay US federal income tax at 35% on its interest income under the promissory note.

(8) Credit Suisse Group guaranteed the transaction obligations of MadPar.

(9) TBNZE agreed to pay a GPF of 2.80% p.a. to MadPar for procuring the Credit Suisse guarantee.

(10) WBC guaranteed the transaction obligations of TBNZE and TBNZ (UK). (As in the Koch transaction, no fee was payable by CSFB for this guarantee, because the obligations of TBNZE and TBNZ (UK) to the CSFB group were largely performance rather than monetary obligations and therefore did not put Westpac's balance sheet at risk. Similarly, the principal monetary obligations owed by the Westpac group to the CSFB group were the periodic NZD swap payments that WBC itself was directly liable for as the swap counterparty.)

(11) Credit Suisse First Boston, Inc. entered into a NZD interest rate swap with Westpac, and Westpac entered into a corresponding swap with TBNZE.

[150] The final pricing gave CSFB a net benefit, assuming a hedge cost of 0.18% p.a., of 7.00% + 2.80% - 7.8033% - 0.18% = 1.8167%, compared with Westpac's benefit of 1.85% p.a. before a five year TLP of 0.08%.

[151] The CSFB transaction was different from the Koch transaction in the following key respects:

(1) Investor (TBNZ (UK)) was to purchase a US partnership interest rather than shares in a US company and the partnership would pay US tax on its interest income. Its effect was that TBNZ (UK) obtained New Zealand tax relief by way of foreign tax credits rather than the CTR regime.

(2) There was an internal transfer of the Class A Interests from TBNZE to TBNZ (UK) at the beginning of the transaction, and a reverse

transfer at the end. (These transfers were a product of the two-tier Investor/Investor Parent structure which enabled Investor to fully offset the US tax incurred on its partnership income against its New Zealand tax liability on that income, but they also intended that any joint and several partnership liabilities incurred by TBNZ (UK) during the course of the transaction would remain quarantined within that company, and not give rise to any claims against the repurchase price payable by MadPar.)

(3) The partnership was consolidated by Westpac for financial reporting purposes, whereas the corresponding party in the Koch transaction (Kiwi) was not consolidated.

(4) The swap between Westpac and CSFB was a NZD interest rate swap rather than a USD/NZD cross-currency swap, as Westpac and CSFB were not able to reach agreement on price for a currency swap. CSFB apparently undertook a currency swap with a third party.

(5) The sale and repurchase prices for the A Partnership Interests were denominated in AUD rather than NZD. (The Australian tax concern behind this feature did not come to light until after Koch had been closed.)

[152] The relevant periodic cashflows were as follows:

(1) CSFB Inc paid interest in arrears to the Partnership at the fixed rate of 6.287% p.a. on the loan note.

(2) The Partnership was liable for and paid US federal income tax at 35% on interest received from CSFB, less general expenses.

(3) The Partnership paid 99.5% of its cash flow (as defined in the amended and restated partnership agreement) to TBNZ (UK) as holder of the A Partnership Interests (under clause 6.08 of the sale and

repurchase agreement, MadPar covenanted that TBNZ (UK) would receive a minimum return of 7.8033% p.a. on NZD500m. This was expected to be equal to 99.5% of the partnership's cash flow, given the loan note interest rate of 6.28% on principal of NZD962m, US tax at 35% and allowing for defined partnership expenses).

(4) TBNZ (UK) paid a NZD dividend to TBNZE sufficient to allow TBNZE to meet its GPF and swap payment obligations.

(5) TBNZE paid MadPar a GPF of 2.80% p.a. of NZD500m.

(6) TBNZE made a NZD fixed rate payment to Westpac of 7.00% p.a. and WBC made a NZD floating rate payment to TBNZE of NZD-BBR-FRA pursuant to the internal interest rate swap (the rate of 7.00% p.a. was the NZD five year swap mid-rate at the time the transaction was entered into).

(7) Westpac made a NZD fixed rate payment to CSFB of 7.00% p.a. and CSFB made a NZD floating rate payment to Westpac of NZD-BBR-FRA pursuant to the interest rate swap.

[153] CSFB was terminated in August 2001 (to allow another transaction, known as BANA 1, to proceed).

Rabo 1

[154] Westpac entered into the Rabo 1 transaction on 14 January 2000. Its principal features were:

(1) Westpac Overseas Investments Ltd (WOIL or Investor) purchased NZD700m of preference shares in Rabo Investments (UK) Ltd (RIL or Issuer) from RILB, subject to a forward sale agreement with Hold BV at a price of AUD547m.

(2) To enable Hold BV to pay the forward sale price, WOIL agreed to sell AUD547m to Hold BV for NZD700m on termination of the transaction, subject to any earlier partial termination(s).

(3) The dividend rate on Issuer's preference shares was 9.2026% p.a. on principal of NZD700m.

(4) RILB guaranteed Hold BV's transaction obligations.

(5) WOIL agreed to pay a GPF of 2.92% p.a. on NZD700m to Hold BV for procuring the RILB guarantee (unless the number of preference shares fell below 400,000,000 in which case the fee would be increased to 2.98%).

(6) WOIL guaranteed Westpac's swap obligations to Hold BV.

(7) WOIL granted a charge over the preference shares in Issuer to Hold BV.

(8) Hold BV entered into a NZD/USD cross-currency swap (the basis swap) with Westpac under which Westpac paid 7.9092% p.a. (the swap rate less a spread of 0.13%) on NZD700m and Hold BV paid USD-LIBOR-BBR on USD364m.

[155] The principal differences between Rabo 1 and Koch were:

(1) Investor Parent (WLD) was funded by a NZD loan from Westpac rather than TBNZ's cash reserves. This was possible because the UK's withholding tax rules were different from the US.

(2) As the above loan carried a fixed interest rate, there was no need for an internal Westpac NZD interest rate swap in Rabo 1.

(3) For the Australian tax reason explained in respect of the CSFB transaction, the forward repurchase price of the preference shares in

Rabo 1 was also denominated in AUD rather than NZD. (In the CSFB transaction, both the sale and repurchase prices for the partnership interests were denominated in AUD. The change in Rabo 1 was a simplification only and did not affect the New Zealand or Australian tax treatment of the transaction or the commercial result.)

(4) In conjunction with the denomination of the forward repurchase price in AUD, Rabo 1 contained a forward NZD/AUD exchange arrangement. (This replaced the AUD/NZD principal-only swap in the CSFB transaction. Again, this was a simplification that did not affect the New Zealand or Australian tax treatment or the commercial result of the transaction.)

(5) Investor was able to terminate Rabo 1 at any time on five business days notice rather than only on the occurrence of certain events.

(6) There was no Westpac guarantee in Rabo 1; instead Rabobank was satisfied with security over the preference shares, a right of set-off in relation to the guarantee from WOIL of Westpac's swap obligations and a compensation agreement.

[156] The relevant cash flows were as follows:

(1) Issuer paid a NZD dividend to WOIL of 9.2062% p.a. on the preference shares.

(2) WOIL paid a NZD dividend to WLD equal to the dividend from Issuer less the GPF.

(3) WOIL paid a GPF to Hold BV of 2.92% p.a. of NZD700m.

(4) WLD paid interest to Westpac under the loan referred to above.

(5) Under the basis swap, Westpac made NZD fixed rate payments to Hold BV of 7.9092% p.a. (the five year swap rate less 0.13%) on

NZD700m and Hold BV made payments of three month USD LIBOR on USD364m to Westpac.

(6) Westpac made a subvention payment to WLD. (In other words, Westpac paid WLD to transfer its actual or estimated tax loss for the period to Westpac.)

Rabo 2

[157] Westpac entered into the Rabo 2 transaction on 9 June 2000 by advancing NZD800m. The elements of the transaction were materially identical to Rabo 1 except that the GPF was increased from 2.92% to 3.2512% (unless the size of the transaction was reduced to or below NZD500m, in which case the fee would be increased to 3.3012%). The basis swap provided for Westpac to pay 7.4288% p.a., less than 7.9092% for Rabo 1, and minus a swap rate spread of 0.12%. Also Lloyds provided a TSB letter of credit for NZD300m, and the interest rate swap was for NZD300m rather than for the whole transaction amount of NZD800m.

First Data Ruling

[158] Westpac entered into a tenth structured finance transaction. The counterparty was First Data Corporation. Its elements were materially identical to the other nine transactions. In chronological terms it was the second in the series after Koch. Westpac applied to the Commissioner on 28 May 1999, after entering into both Koch and First Data, for a binding ruling that the statutory tax avoidance provisions would not apply to negate or vary its proposed tax treatment of First Data. The bank never sought binding rulings for Koch or the other eight transactions.

[159] In a decision delivered on an interlocutory appeal against an earlier judgment in this proceeding the Court of Appeal noted: *Westpac Banking Corporation v Commissioner of Inland Revenue* [2009] 2 NZLR 99:

> [23] As a part of the binding rulings process, Westpac disclosed to Rulings the First Data transaction documents. Its solicitors were also involved in an extensive dialogue with Rulings, during which they buttressed

> their arguments with opinions offered by allegedly independent experts. The material which we have seen, however, suggests that Rulings did not have access to secondary documents associated with First Data as to the provenance of the transaction (for instance, board papers and other background documentation, emails, correspondence, notes as to how the deal had been developed and so on).
>
> [24] In the end, a favourable, but reasonably narrow, ruling was issued on 19 January 2001. It gave a very particular description of the transaction including a number of statements as to the underlying commercial drivers and the intentions of the parties. More significantly, perhaps, it is expressed as being subject to a number of conditions associated broadly with the commerciality of the components of the transaction. Some of these conditions were expressed using terms such as 'arm's-length basis at market rates', 'stand-alone basis' and 'common banking practice'.

[160] Some time after issuing the First Data ruling the Commissioner changed his mind about the correct interpretation of the tax avoidance provisions as they applied to the structured finance transactions. The Commissioner gave Westpac notice in June 2003 that he was reviewing the tax treatment of the other nine transactions. He was duty bound to take that course if he concluded that his earlier view was wrong: *Miller v Commissioner of Inland Revenue* (1993) 15 NZTC 10,187 at 10,203-10,204, Blanchard J.

[161] The Commissioner's amended assessments started in 2004. It is common ground that the First Data ruling was limited in its application to that specific transaction; Westpac does not argue that its terms bind or affect the Commissioner's application of the general anti-avoidance provisions to the other transactions.

[162] Nevertheless, in written argument Mr Farmer devoted considerable attention to the First Data ruling. In summary, he submits that it is relevant as 'part of the factual matrix relevant to (1) the broad tax avoidance arrangements alleged by the Commissioner'; (2) the evaluation of commercial aspects of the transactions; and (3) 'to counter pejorative aspects of the Commissioner's tax avoidance allegations'. In support of this third ground Mr Farmer gave examples of allegedly emotive language used by the Commissioner's counsel at trial in the *BNZ Investments (No 2)* case. That element was not, however, a feature of argument in this trial.

[163] I do not accept the First Data ruling is relevant on either of the surviving two grounds advanced by Mr Farmer. It is unnecessary to discuss either of them. Time

has moved on in the eight years since the First Data ruling was issued, and this inquiry is much more extensive than that which the Commissioner was able to undertake from May 1999 onwards. What the Commissioner may or may not have concluded on the material then available to him is of no consequence here.

[164] Mr Farmer similarly addressed considerable written argument to what he called the 'Commissioner's attempt to discredit the First Data ruling', asserting that the IRD Rulings section knew that First Data was a 'tailored' structured finance transaction, the relationship between the GPF and dividend rates, and that the transaction could be pre-tax negative for the Westpac group.

[165] Again I do not regard these points as material. Mr Brown did not attempt to discredit the First Data ruling. And I am not assisted by the state of IRD Rulings' knowledge or otherwise in a very different context.

[166] Mr Brown gave notice at the start of trial of the Commissioner's intention to challenge the admissibility of evidence relating to the ruling. He did not pursue a formal objection after I advised that the ruling itself would have little, if any, relevance to the questions for determination in this trial.

[167] In cross-examination of Mr Gibbs, Mr Brown used some of the correspondence passing between the Commissioner and Westpac's solicitors during the First Data approval process. Mr Brown highlighted material contradictions between Mr Gibbs' evidence and contemporaneous documents, on the one hand, and explanations given by the bank's solicitors in answers to questions by the Commissioner, relating particularly to the GPF, on the other. The Commissioner did not seek, however, to set aside the First Data Ruling in reliance on the statutory grounds of misrepresentation or non-disclosure. I regard its existence as of no more than historical interest.

Legal Principles

[168] The Commissioner has invoked his power to avoid the transactions pursuant to s BG 1 which materially provides:

Arrangement Void

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

Enforcement

(2) The Commissioner, in accordance with Part G (Avoidance and Non-Market Transactions), may counteract a tax advantage obtained by a person from or under a tax avoidance arrangement.

[169] The terms 'arrangement', 'tax avoidance' and 'tax avoidance arrangement' are defined in s OB 1, as follows:

> **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, EH 1, EH 42, GB 1, and GC 12, 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:

[170] I agree with Wild J in the *BNZ Investments (No 2)* case at [114] that the Supreme Court's decisions in *Ben Nevis* and *Glenharrow* should render a review of the pre-existing case law otiose, subject of course to the qualification that some earlier decisions may remain material to the specific issues arising here. I note particularly *Elmiger v Commissioner of Inland Revenue* [1966] NZLR 683 (upheld on appeal [1967] NZLR 161 (CA)); *Newton v Commissioner of Taxation of the Commonwealth of Australia* [1958] AC 450; *Challenge Corporation v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA) (reversed [1986] 2 NZLR 555 (PC)); *Commissioner of Inland Revenue v Auckland Harbour Board*

[2001] 3 NZLR 289 (PC); *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 (PC); the *BNZ Investments (No 1)* case; and *Peterson v Commissioner of Inland Revenue* [2006] 3 NZLR 433(PC).

[171] Nevertheless, a review of the *Ben Nevis* and *Glenharrow* principles is necessary here for three reasons. First, Mr Farmer makes the contested submission that *Ben Nevis* is 'merely a restatement of the proper approach to the general anti-avoidance provision as it had been articulated in earlier decisions'. Mr Farmer was referring particularly to the judgment of Richardson J in *Challenge* at 549-550 which is said to formulate the classic scheme and purpose approach; he describes it as 'the foundation of the reasoning of the majority in *Ben Nevis*'. Second, Mr Farmer submits that the *BNZ Investments (No 1)* decision is indistinguishable and its authority is fatal to the Commissioner's case. And, third, the Commissioner relies significantly on the more than 'merely incidental' purpose or effect test in the alternative, which did not arise for direct consideration in *Ben Nevis*.

[172] While all members of the Supreme Court were unanimous in *Ben Nevis* in dismissing the taxpayer's appeals, they divided in their approach. I am guided by the majority (Tipping, McGrath and Gault JJ). The concurring minority (Elias CJ and Anderson J) differed on the interrelationship between the specific provisions and s BG 1.

[173] In support of the Commissioner's case on tax avoidance, Ms Rebecca Ellis cites authority from Australia and Hong Kong. She observes that they appeared to have some attraction for the Court during argument in *Ben Nevis*. However, I have not considered that authority in detail. The distinctive terms of s BG 1, the Court's comprehensive discussion of the principles in *Ben Nevis* and *Glenharrow* and the guidance available from the other leading New Zealand authorities is sufficient. And, as Mr Farmer observes, there are material differences in the Australian statutory provisions.

(1) Ben Nevis and Glenharrow

[174] I agree with Ms Ellis in rejecting Mr Farmer's first submission that *Ben Nevis* is essentially a restatement of Richardson J's settled principles in *Challenge*. The Supreme Court majority opened in *Ben Nevis* by summarising Woodhouse P's dissenting judgment in *Challenge* followed by a brief reference to the facts: at [84]-[85]. In *Challenge* the taxpayer had bought and consolidated into its group a company with no assets or debts but a large deductible loss. The taxpayer then transferred the loss to other subsidiaries, by using a specific subvention or offsetting provision, for the purpose of reducing the group's assessable income.

[175] The *Ben Nevis* majority summarised Richardson J's scheme and purpose approach in *Challenge* as follows:

> [88] In *Challenge Corporation*, Richardson J decided that taking advantage of the statutory provisions in relation to the tax treatment of subvention payments was consistent with the very specific scheme and purpose of the statutory provisions relating to grouping of companies and treatment of losses. These provisions had no purpose but to allow an offset for tax purposes. The transactions contemplated were simply tax concepts which had no reality except in relation to income tax. Parliament could not have intended that s 99 would deprive taxpayers of a specific structure provided for by the Act. Richardson J held, in effect, that literal compliance met the statutory purposes and it was not necessary for him to take into consideration the circumstances in which the loss company became part of the group. It was not consistent with the statutory purposes to treat such subvention arrangements as tax avoidance.
>
> [89] The effect was to reconcile conflicting provisions by reading down the scope of s 99 so that it did not operate on arrangements that complied with the particular specific provision in the legislation. The scheme and purpose of the legislation required that s 99 be read in the context of the special concession provisions which were dominant.
>
> [Citation omitted]

[176] I read *Ben Nevis* at [84]-[89] as expressing what Ms Ellis called a 'diplomatic rejection' of Richardson J's judgment in *Challenge* while endorsing Woodhouse P's approach in the same case. *Ben Nevis* marked out two clear points of departure from Richardson J. One was from his emphasis on the specific provision, thereby reading down or negating the reach of the general anti-avoidance section. The other was

from a formalistic or juristic approach which necessarily excluded an examination of the circumstances in which the deductible loss arose.

[177] These points of departure are reinforced in the immediately following passages in *Ben Nevis*. The Court apparently endorsed Lord Templeman's observation for the Privy Council majority in *Challenge* at 559 that the general anti-avoidance provision 'would be useless if a mechanical and meticulous compliance with some other section of the Act were sufficient to oust [the general anti-avoidance provision]': *Ben Nevis* at [92] and [104]. It observed:

> [94] The Privy Council majority accepted the central importance of the scheme and purpose of the specific provision. But it differed from Richardson J's conclusions on the application of that approach to the case. The Privy Council did not accept that on a purposive approach the application of s 99 could be limited in a way that ignored **the economic reality of the transaction as contemplated by the specific provision**. For a profitable company to buy into the shareholding of a loss company outside its group, and then to offset those losses, involved 'pretence'. When a taxpayer sought to obtain a tax advantage without suffering the cost Parliament intended be suffered, this would amount to tax avoidance.
>
> [Emphasis added and citations omitted]

Woodhouse P had earlier postulated the 'economic reality' test in *Challenge* at 535.

[178] The Court also referred in *Ben Nevis* at [96]-[98] to decisions subsequent to *Challenge* which had applied the scheme and purpose approach (*BNZ Investments (No 1)*, *Miller* and *Peterson*), before concluding that that approach does not simply require a Court 'to focus on the specific provisions in isolation of wider considerations': at [99].

[179] The Court set out to resolve the 'continuing uncertainty about the interrelationship of the general anti-avoidance provision with specific provisions'. It mandated a principled approach, giving 'proper overall effect to statutory language that expresses different legislative policies' and 'focusing objectively on features of the arrangements involved…': at [102]. It noted that the specific and general avoidance provisions are 'meant to work in tandem': at [103].

[180] The Court then said:

> [105] **The key statutory concept in the general anti-avoidance provision is of a tax avoidance arrangement, as Parliament has defined it.** By means of the definition of "tax avoidance", a tax avoidance arrangement includes an arrangement which directly or indirectly alters the incidence of any income tax. It is arrangements of that and allied kinds which are void against the Commissioner under s BG 1(1). An arrangement includes all steps and transactions by which it is carried out. Thus, tax avoidance can be found in individual steps or, more often, in a combination of steps. Indeed, even if all the steps in an arrangement are unobjectionable in themselves, their combination may give rise to a tax avoidance arrangement.
>
> [Emphasis added]

[181] The Court noted also:

> [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…

[182] It is, I think, appropriate to recite in full *Ben Nevis'* ratio:

> [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.
>
> [Emphasis added]

[183] These passages echo Lord Nolan's observation in *Commissioner of Inland Revenue v Willoughby* (1997) 70 TC 57 at 116 (approved in *Peterson* at [38]) that:

> The hallmark of tax avoidance is that the taxpayer reduces his liability to tax without incurring the economic consequences that Parliament intended to be suffered by any taxpayer qualifying for such reduction in his tax liability …

[184] Ms Ellis submits that s BG 1 'only comes into play once the taxpayer has satisfied the Court that the component parts of an arrangement prima facie comply with the black letter taxing provisions' ('a condition precedent' to s BG 1's application). I assume that this submission is based upon a literal adoption of the first three sentences in *Ben Nevis* at [107] read in isolation from the rest of the paragraph as a whole. I doubt, however, whether it correctly reflects the Commissioner's case.

[185] Some context is necessary. Discrete deductibility as well as avoidance issues arose in *Ben Nevis*. The Supreme Court determined the former in the taxpayer's favour before considering the correct approach to the latter: at [69] onwards. I read the first three sentences in *Ben Nevis* at [107], in context with the observations in [103]-[106], as addressing the exercise which the Court had already undertaken on the taxpayer's claim for deductions.

[186] I accept that the first three sentences from [107], taken by themselves, are open to interpretation as suggesting that the avoidance inquiry will proceed only if all elements of the arrangement satisfy the specific provisions. That is because the

passage does not qualify the extent to which those provisions must be satisfied in order to justify the general avoidance inquiry.

[187] However, taking [107] as a whole and in context, I do not read *Ben Nevis* as mandating that the avoidance inquiry will not proceed unless the taxpayer shows that the use made of a specific provision is within its intended scope. I construe the first three sentences in [107] as reinforcing the Court's point made in [106] that proof of a taxpayer's compliance with a specific provision does not exclude the scope for a wider inquiry into the arrangement as a whole. Wild J, when postulating a distinctive two-step inquiry, was apparently of the same opinion: *BNZ Investments (No 2)* at [122] and [123].

[188] An anomaly would arise otherwise; for example, a Court might disallow a claim for a relatively minor deduction, thus barring it from proceeding to an avoidance inquiry into the transaction as a whole. That result would be contrary to the way the Commissioner has argued his case and to *Miller v Commissioner of Inland Revenue* [1999] 1 NZLR 275 (CA) at 298-299.

[189] There may be cases where the taxpayer's misuse of a specific provision is so extreme or clear cut that a finding of tax avoidance will inevitably follow. But a wider inquiry will necessarily be appropriate where the arrangement involves a number of composite or interdependent steps, including the step which is the subject of a disputed deductibility claim. Its resolution will not normally be decisive of the avoidance inquiry.

[190] The additional elements necessary to constitute avoidance emerge from the succeeding sentences in *Ben Nevis* at [107]. Principally, they are the alteration of the incidence of income tax and the use of the specific provisions in a way not intended by Parliament which in totality constitute a tax avoidance arrangement. That inquiry, as [108] and [109] envisage, is wide ranging and includes, significantly, the provision's use in the light of commercial reality and the transaction's economic effect. The Court had earlier emphasised that that use, assuming it was lawful, cannot be isolated from wider considerations: at [99].

[191] The Commissioner challenges Westpac's 'black letter' or technical right to deduct the GPF. He says that the bank's claim fails to satisfy the specific deductibility provisions. He says also that the fee was a part of the wider arrangement which he impugns. He does not suggest that a finding adverse to Westpac on deductibility should exclude the avoidance inquiry. Nor does he suggest that a finding of unlawfulness on deductibility is necessarily decisive of avoidance.

[192] I propose to consider the case in this way. I shall determine the discrete deductibility dispute first. It is logical to carry out that exercise after reviewing the conduit and foreign tax credit provisions which exempted the bank's income from taxation on these transactions. They provide the appropriate statutory setting for considering the specific deductibility issue because the expense giving rise to a deduction is incurred in deriving income. The deduction and the income (exempt or not) are inextricably linked. It would be artificial to consider the two in isolation from each other.

[193] Once the deductibility issue is determined, I will then consider avoidance. In the particular context of this case one inquiry logically follows the other. The permissibility of deducting the GPF and its consequences lie at the heart of the avoidance inquiry and the Commissioner's case on reconstruction. The lawfulness of Westpac's claim for the GPF deduction may be relevant but not necessarily decisive. The other factors listed for consideration in *Ben Nevis* at [108] and [109] will then come into play. Wild J followed a similar approach in *BNZ Investments (No 2)* at [118]-[138].

[194] In summary, *Ben Nevis* represents, I think, a significant shift in identifying the principles to be applied when construing s BG 1, mandating a broader inquiry than was previously required – a 'wider perspective' – consistent with settled principles of statutory interpretation: at [99]. Ms Ellis observes that the phrase 'scheme and purpose' is conspicuously absent from the ratio. I doubt that the Court was rejecting the scheme and purpose approach of itself but was instead expanding its scope. The previous constraints imposed by a legalistic focus, to the exclusion of economic realism, have gone.

[195] I read *Ben Nevis* as prescribing a combined form and substance test. An analysis of the form or nature of the contractual relationship remains as the starting point in a tax avoidance inquiry; I agree with Mr Farmer that *Ben Nevis* does not authorise a Court to bypass the legal structure and move straight to a substance assessment (although, as I shall explain, his stricture failed to inhibit his junior, Mr Richard Green, from relying upon substance based arguments inconsistent with legal form on the specific issue of the GPF's deductibility).

[196] Conversely, the legal structure cannot shield a transaction from substantive scrutiny where the general anti-avoidance provision is invoked: *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA) per Richardson J at 168; *Buckley v Young* [1978] 2 NZLR 485 (CA) per Richardson J at 490; *Glenharrow* at [40]. Mr Farmer does not suggest otherwise or that the form of the transaction prevails over its substance. The ratio of *Ben Nevis* at [107] and [108] is, I think, designed to prescribe the permissible scope of the substance inquiry.

[197] Some other notable aspects of *Ben Nevis* are that:

(1) Lord Hoffmann's obiter characterisation of the general anti-avoidance (*Auckland Harbour Board* at [11]) as a 'longstop' is no longer good law: at [100];

(2) English decisions are of limited assistance because tax legislation in that country has never had a general anti-avoidance provision: at [110];

(3) The tax avoidance inquiry does not deprive taxpayers 'of tax beneficial choices'; they retain the 'freedom to structure transactions to their best tax advantage', providing that the method applied is not proscribed by the general anti-avoidance provision: at [111];

(4) Section BG1 is 'deliberately general', and it is not possible for the Court to give any greater guidance in the particular case – in most

> cases it will be possible 'to decide on which side of the line a particular arrangement falls': at [112].

[198] *Glenharrow* is also directly material even though it was decided in a slightly different statutory context. The Supreme Court considered the extent to which the taxpayer's subjective purpose was relevant to whether a transaction was designed to defeat the Goods and Services Tax Act 1985. The Court unanimously approved Lord Denning's test propounded for the Privy Council in *Newton* at 465, holding that the phrase 'purpose or effect' (replicated in s OB 1) referred not to the taxpayer's motive but to the objective which the arrangement sought to achieve; that is, 'the end in view'. (I agree with Ms Ellis that, with respect, the Supreme Court's statement in *Ben Nevis* at [81] that the statutory changes made to the anti-avoidance provisions in 1974 'dispensed with Lord Denning's predication test in *Newton*' is expressed too widely; a key component remains, as *Glenharrow* confirms.)

[199] *Glenharrow* emphasises that the anti-avoidance provisions are concerned with the purpose of the arrangement, and not the purpose of the parties. When the parties' subjective purpose is put aside, the purpose of the arrangement is determined by considering its effect or what it has achieved. (However, subjective intention may be relevant to the issue of whether or not, for example, there was a legitimate business purpose for a scheme: see *Ben Nevis* at [138] and [148], discussing evidence given by the architect of the Trinity scheme about the existence of an insurable risk.) The Court then works backwards 'to determine what objectively the arrangement must be taken to have had as its purpose': *Glenharrow* at [37]-[38]. It is impermissible to judge the transaction by what actually happened subsequently: at [51].

[200] Moreover, the purpose of an arrangement may properly be inferred from its effect: *Glenharrow* at [36], [39] and [40]. On that approach the Supreme Court concluded that the taxation effect, a GST refund, was totally disproportionate to the economic burden undertaken by the parties: at [52]-[55]. The taxation advantage was contrary to all economic reality.

[201] Also directly material to this case is the Court's citation with approval (at [40]) of this passage from Lord Hoffmann's speech in the *Auckland Harbour Board* case at [11]:

> [The general anti avoidance rules are] aimed at transactions which in commercial terms fall within the charge to tax but have been, intentionally or otherwise, structured in such a way that on a purely juristic analysis they do not. This is what is meant by defeating the intention and application of the statute.

'Merely Incidental'

[202] The Commissioner pleads that a more than merely incidental purpose or effect of each transaction was to obtain deductions for income tax purposes from the funding costs of the transaction, including the GPF, while having no liability for tax on income arising from it (see para 19, statement of defence ([37]-[40] above)). Accordingly, I must consider the nature and applicability of the 'not merely incidental' test in this case, particularly given the close nexus between Westpac's use of its tax shelter or capacity and each transaction's implementation.

[203] It is appropriate to repeat that a tax avoidance arrangement is defined as one: s OB 1:

> … that directly or indirectly—
>
> (a) Has tax avoidance as its purpose or effect; or
>
> 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**:
>
> [Emphasis added]

[204] The current definition was enacted in 1994. Like its 1974 predecessor, it provides two alternatives. The first alternative, of a transaction having tax avoidance as 'its purpose or effect', postulates a focus on the singular – that is, the sole, principal or dominant purpose or effect of the arrangement: see *Accent Management Ltd v Commissioner of Inland Revenue* (2007) 23 NZTC 21,323 (CA) (later *Ben Nevis*) at [141] per William Young P.

[205] The second alternative has a wider scope, allowing for inclusion of multiple purposes or effects. Its wording seems designed to end the pattern of appellate inconsistency in treating the concurrence of discernible commercial and tax avoidance purposes: see Richardson J in *Challenge* at 547. A tax avoidance purpose or effect must be more than merely incidental to any other purpose or effect, such as ordinary business or family dealings, to constitute statutory avoidance. Inclusion of an adjectival phrase such as 'not merely' is unusual in a statute; and its presence is not without difficulty in the context of tax legislation.

[206] However, when used in conjunction with the word 'incidental', I think the phrase 'not merely' is designed to emphasise that a tax avoidance purpose, if found, will offend s BG 1 unless it naturally attaches or is subordinate or subsidiary to a concurrent legitimate purpose or effect, whether of a commercial or family nature. Identification of a business purpose will not immunise a transaction from scrutiny where tax avoidance can be viewed as 'a significant or actuating purpose which ha[s] been pursued as a goal in itself': see *Tayles* per McMullin J at 736. Conversely, a transaction will not offend where tax avoidance naturally attaches to that other acceptable purpose or effect.

[207] The 'not merely incidental' test did not arise for direct consideration in *Ben Nevis*. But the Supreme Court emphasised a taxpayer's freedom to structure transactions to its best possible tax advantage provided it did not act in a way proscribed by s BG 1: at [111]. The Court also emphasised the need to apply the statutory language of the provisions themselves, warning against imposing 'judicial glosses' on the plain words of a specific provision and, a fortiori, the general anti-avoidance section: at [104]. What is perhaps most germane to this case is the Court's observation that:

> [114] … It will rarely be the case that the use of a specific provision in a manner which is outside parliamentary contemplation could result in the tax avoidance purpose or effect of the arrangement being merely incidental …

[208] I think that two judicial statements continue to provide authoritative guidance on the 'not merely incidental' test. First, in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546 (PC) (*Europa No 2)* Lord Diplock said this at 556:

> … the section in any case does not strike down transactions which do not have as their main purpose or one of their main purposes tax avoidance. It does not strike down ordinary business or commercial transactions which incidentally result in some saving of tax. There may be different ways of carrying out such transactions. They will not be struck down if the method chosen for carrying them out involves the payment of less tax than would be payable if another method was followed. In such cases the avoidance of tax will be incidental to and not the main purpose of the transaction or transactions which will be the achievement of some business or commercial object …

[209] Second, I refer to Woodhouse P's observations in *Challenge* at 533-534:

> Clearly enough para (b) is designed to catch an arrangement whenever it has a tax avoidance purpose (or effect) even if it has another and real purpose which is not tax avoidance. But the bracketed words enable a 'merely incidental' tax avoidance purpose to be disregarded. So the meaning of that qualifying phrase is all important. Does it have the rather exiguous meaning and effect of excusing only 'the casual' or 'the minor' or 'the inconsequential' tax avoidance purposes? If so, many 'ordinary' dealings would probably be caught by s 99 because inevitably the associated tax purpose could seem stronger than that. And the problem would be magnified if as well the assessment had to include estimates of the taxpayer's motives. However, I do not think the phrase 'merely incidental' does have such a limited effect and in accord with *Newton v Commissioner of Taxation* [1958] AC 450 I am satisfied as well that the issue as to whether or not a tax saving purpose or effect is 'merely incidental' to another purpose is something to be decided not subjectively in terms of motive but objectively by reference to the arrangement itself.
>
> **As a matter of construction I think the phrase 'merely incidental purpose or effect' in the context of s 99 points to something which is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant**. Many taxpayers when considering a course of action are likely to appreciate and welcome an opportunity provided by the Act for achieving some tax benefit as an aspect of it. But this should not bring the transaction or transactions almost automatically within the avoidance provisions of s 99. By itself conscious recognition and acceptance that a commercial transaction will be accompanied by a degree of tax relief is not the issue. Already I have mentioned the example put forward in this case of goods manufactured in New Zealand and sold overseas in the knowledge that surrounding costs were likely to be assisted by a tax saving which would not be applicable in the case of internal sales. But it could hardly be said in such a case that the trading had been pursued to gain the tax advantage as an end in itself. Conventional exporters do not trade to save tax but to achieve profits. To put the point in another way, among the cost factors to be taken into account one of them, to a greater or lesser extent, would sensibly and properly be the tax factor. So regarded, the tax saving purpose intended as a support to the operation could in the ordinary course no more be labelled an end in itself than the purpose of avoiding or minimising any other cost likely to affect the operation. In other words in the usual case the associated tax purpose ought not to be and in my opinion would not be regarded as more than a 'merely incidental purpose'.
>
> [Emphasis added]

[210] Mr Farmer relies on McGechan J's statement at first instance in *BNZ Investments (No 1)* at [72]:

> It is a recognised reality that most business or family transactions have tax minimisation (to use a neutral term) as one of their purposes or effects, and with a degree of a significance such that cannot realistically be termed merely 'incidental'. Read literally, s 99(2) avoids for tax purposes the majority of business and family transactions. Whatever else may be said, it is widely accepted that extreme outcome cannot have been intended by Parliament. The difficulty has been to ascertain the intended boundaries. The purest says this is an exercise in statutory interpretation. The realist might say that Courts have been left to resolve the question on a policy basis.

I have not derived any assistance from McGechan J's general observation in this regard.

[211] The cases to which the 'not merely incidental' test might apply lie within a spectrum. At one end are the obvious examples where, despite 'black letter' or technical compliance, a transaction has tax avoidance as its transparent purpose or effect. At the other end are transactions having a clear and definable commercial purpose or effect which results in an alteration of taxation liability that plays no part in the decision on whether to proceed.

[212] Transactions falling in between, where a reduction in the incidence of tax is a real or appreciable purpose but there is also a concurrent commercial purpose, present the difficulties. Drawing the line between permissibility and avoidance in such cases requires an evaluative judgment, to be exercised according to the facts and degree of the particular circumstances.

(3) BNZ Investments (No 1)

[213] Westpac portrays the Commissioner's challenge to these transactions as an attempt 'to reargue *BNZI* on different grounds'. In *BNZ Investments (No 1)* the Commissioner alleged unsuccessfully that the bank had entered into a tax avoidance arrangement. Deductions claimed for interest on funds borrowed were a part. The funds were used to buy redeemable preference shares in a special purpose vehicle, from which the dividend stream was exempt income. Mr Farmer submits that, apart

from the GPF – which he says is 'simply an aspect of determining a market interest rate' – the Commissioner's case against Westpac is primarily based on the existence of factors which were all present in the redeemable preference share transactions entered into by the taxpayer in *BNZ Investments (No 1)*.

[214] Mr Farmer submits that the Court of Appeal, upholding McGechan J (*BNZ Investments Ltd v Commissioner of Inland Revenue* (2000) 19 NZTC 15,732), recognised the legality of capitalisation asymmetry; pre-tax negative and post-tax positive transactions; sharing tax benefits; reducing the bank's ETR by entering into the transactions; and deducting funding costs.

[215] Mr Farmer relies on Richardson P's conclusion in *BNZ Investments (No 1)* at [56]:

> … The upstream arrangement was a standard commercial RPS investment which in terms of the Income Tax Act entitled BNZ to a deduction for interest on the sums borrowed for investment in the RPS and provided that the dividends on the RPS would be exempt income as inter-company dividends. The RPS investments are a far cry from the self-cancelling and circular schemes that have come before the New Zealand and Australian Courts under the general anti-avoidance provision…

[216] Accordingly, Mr Farmer submits, *BNZ Investments (No 1)* stands as authority for the rejection of the very indicia of tax avoidance upon which the Commissioner relies to impugn Westpac's taxation treatment of these transactions. The defining line was drawn in that case, he says, at the bank's investment in the preference shares together with the ancillary security and indemnity arrangements. Associated with it is a clear recognition of a party's right to the fiscal benefits of taxation asymmetry.

[217] I disagree with Mr Farmer. *BNZ Investments (No 1)* is of limited assistance here. While the case was concerned with redeemable preference share transactions, its focus was very different. In brief summary, the transactions at issue in *BNZ Investments (No 1)* converted interest received from abroad into dividends of an exempt character by movement through tax haven jurisdictions. The parties divided the transactions into two categories: one, the 'upstream' category, referred to redeemable preference shares which the bank purchased from the counterparty; the

other, the 'downstream' category, referred to a complex web of transactions undertaken by the counterparty with the funds generated from sale of the redeemable preference shares.

[218] In *BNZ Investments (No 1)* the Commissioner objected to the downstream transactions on the ground that they were tax avoidance arrangements. He did not apparently challenge the upstream transactions. He argued instead that the upstream and downstream categories together constituted one arrangement, to which the bank was necessarily privy. The seven legal issues for determination, listed in the headnote of the report of McGechan J's judgment, illustrate the concentration of argument. It was upon the composition of the relevant arrangement and the lawfulness of the downstream transactions.

[219] McGechan J, upheld by a majority of the Court of Appeal (Thomas J dissenting), dismissed the Commissioner's argument in *BNZ Investments (No 1).* Both decisions are authority that, on the particular facts, there were two distinct upstream and downstream arrangements. On this basis the bank was not privy to questionable transactions undertaken downstream by CML. (I note, however, that the Privy Council has since doubted the majority decision, expressing preference for Thomas J's dissent: *Peterson* at [34]. Mr Farmer acknowledges that Thomas J was probably correct.)

[220] *BNZ Investments (No 1)'s* relevance to this case is limited to its confirmation of the lawfulness of factoring into the dividend rate a share of the taxation benefit enjoyed by the investor on exempt returns. This is the first element of cross-border asymmetry previously discussed. Its lawfulness as a pricing factor in these transactions is not disputed by the Commissioner. However, the Courts were not required to consider the lawfulness of sharing the taxation benefits of deductions available to the investor for expenditure. That is the second element of domestic asymmetry, and is at the heart of this case.

[221] Mr Farmer also submits that McGechan J clearly understood 'the ability to deduct funding costs incurred in respect of a particular transaction against income from other sources, i.e. use of tax shelter': at [24], [25] and [26], and recognised the

redeemable preference shares as equity, not debt, even though the bank treated them as loans in its accounts.

[222] I do not read *BNZ Investments (No 1)* as validating the use of tax shelter or capacity in a particular transaction; or, to put it conversely, as negating its existence as a possible indicator of tax avoidance. McGechan J's brief reference to the bank's perception of the redeemable preference share investment system as losing attraction given that it was 'facing considerable overall trading losses in the post-crash environment' was simply part of the narrative: at [24]. It was no more than a recognition of the taxpayer's disinterest in participating in a transaction where it was unable to deduct expenditure against its own income. Otherwise *BNZ Investments (No 1)* will not assist in evaluating Westpac's use of its tax shelter in relation to these transactions.

[223] Also, as Mr Farmer recognises, there was no GPF or its equivalent in *BNZ Investments (No 1)*. That point of distinction may of itself prove decisive. As with all cases in this field, a factual difference can be determinative.

Deductibility

Introduction

[224] There is one significant 'black letter' dispute discrete from the avoidance inquiry. The Commissioner has disallowed Westpac's claimed deductions for payment of the GPFs. The amount involved is, of itself, substantial.

[225] However, before addressing the specific deductibility provisions in detail, it seems appropriate first to summarise the two sets of related rules which exempted Westpac's dividend income from taxation – the conduit and foreign tax credit regimes. The bank says their relationship with the interest deductibility rules allowed both the cross-border and domestic asymmetries which were present in its taxation treatment of the transactions. As noted previously, the picture would be incomplete if the relevant income exemption and expense deductibility provisions were not considered together.

Conduit Regime: Koch, Rabo 1 and Rabo 2

[226] Westpac prepared its returns for Koch, Rabo 1 and Rabo 2 in accordance with the conduit tax regime. The Commissioner accepts that Westpac's income was exempted or relieved from tax by those rules. In summarising the legislative policy and the effect of the conduit provisions, I have relied principally upon Mr Green's informed submissions, which the Commissioner does not dispute.

[227] The conduit rules were introduced by the Taxation (Remedial Provisions) Act 1998 with effect from 1 April 1998, and are found in subparts FH, KH, MI and s NH 7. They were part of wider reforms including a revision of the Controlled Foreign Company (CFC) regime. They followed the removal on 1 April 1992 of the exemption for dividends paid between companies which were not part of the same wholly owned group, spelling the end of redeemable preference share transactions of the type considered in the *BNZ Investments (No 1)* case.

[228] However, the introduction of the imputation regime in 1988 allowed for a different type of redeemable preference share transaction. Its purpose was described in an appendix to the report of the Consultative Committee on Full Imputation as follows:

> The principle underlying full imputation is that all income derived by companies is derived on behalf of shareholders and should be taxed as income of the shareholders as it accrues, whether or not the shareholder actually received it. Thus the objective of full imputation is to tax company income, where possible, at shareholders' marginal tax rates. Achievement of this objective requires eliminating the current 'double taxation' of distributed earnings, and adjustment for any difference in the company tax rate and shareholders' marginal tax rates. This objective is achieved under full imputation by allowing companies to attach credit for company tax paid to dividends, with the credits being available for offset against shareholders' tax liabilities.

[229] The purpose of the CFC regime is to attribute income of a foreign company to its owners and tax it accordingly. It prevents resident shareholders from deferring tax on income in their country of residence simply by shifting the income into a foreign company and electing not to repatriate that company's earnings to

New Zealand as dividends. The rationale was described in a report to the Finance and Expenditure Committee at the Bill stage at 55-56 as follows:

> New Zealand's Controlled Foreign Company (CFC) and Foreign Investment Fund regimes tax foreign sourced income earned by New Zealand residents as it accrues. Because tax is imposed irrespective of the extent to which a resident company may be owned by non-residents, the indirect effect is to tax non-residents on foreign sourced income. This is referred to as the conduit issue.
>
> One implication of this is that the competitiveness of New Zealand-based multinationalists is harmed. This is because New Zealand companies must raise capital on world markets and non-resident investors can make global investments without paying tax to intermediate countries. This makes New Zealand-based companies less competitive for making investments into other countries if they are to pay the world rate of return to their non-resident investors… The government's view is, therefore, that conduit relief should be extended, provided this does not create tax avoidance opportunities for New Zealand residents or opportunities for non-residents to reduce tax on their New Zealand sourced income.

[230] New Zealand implemented what is called a full attribution, branch equivalent CFC; no distinction was made between active or non-tainted income (such as from carrying on a commercial operation in the manufacturing field) and passive or tainted income (such as income possessing more of an investment quality): subpart CG. The foreign company is taxed as if it were a foreign branch of the New Zealand resident shareholder subject to New Zealand tax on its world-wide income (a credit for underlying foreign tax paid by the CFC can be claimed against a New Zealand tax liability on attributed CFC income).

[231] One important exemption exists, however, based on the CFC's country of residence. Interests held by New Zealand resident companies in CFCs resident and liable to pay tax in a 'grey list' jurisdiction are relieved from attribution. That grey list, comprised of jurisdictions considered to be countries with robust tax systems incorporating CFC rules similar to New Zealand, includes Australia, the United States and the United Kingdom.

[232] New Zealand follows the international pattern of taxing residents on their world-wide income and non-residents on the income they derive domestically (therefore excluding from the domestic tax base non-resident foreign sourced income). This framework is subject to two exceptions: (1) where a New Zealand

resident interposes a non-resident company to derive income overseas which from an economic viewpoint infringes the world-wide residents tax principle (the CFC regime counteracts this interposition); and (2) where a non-resident holds shares in a resident company that derives income outside New Zealand.

[233] The conduit regime effectively counteracts the interposition of a foreign company, thereby recognising the economic reality of a transaction in terms of residence and source.

[234] Conduit relief applies to a New Zealand resident company's equity investment in a foreign company at two levels: (1) tax otherwise payable on income of a foreign company which would be attributed to a New Zealand resident company under the CFC regime is relieved through a tax rebate: subpart KH; and (2) dividends paid by the foreign company to the New Zealand resident company are relieved from DWP on receipt: s NH 7. In both cases conduit relief applies to the extent the New Zealand company holding shares in the foreign company is itself foreign owned. Only the second applied here.

[235] The conduit rules must be viewed in conjunction with the thin capitalisation regime, earlier introduced with effect from 1 April 1996. Its purpose was to prevent foreign controlled businesses from excessively debt funding their New Zealand operations, thus increasing interest expenditure deductions and reducing New Zealand tax payable. It recognises a company's entitlement to choose whether to raise funds by way of debt or equity. By limiting interest deductions, the regime does not deny particular interest expenditure. Instead it focuses on overall debt levels measured as a percentage of total assets (that is, where it exceeds both 75% of its individual debt percentage and 110% of the debt percentage of its world-wide group) (the so-called 'safe harbour').

[236] An on-lending concession was introduced to the thin capitalisation rules. Both debt and assets are reduced by the total of all financial arrangements whereby the New Zealand group provides funds to non associated parties at an arm's length interest rate. Its specific benefit is for financial intermediaries such as banks operating in the business of borrowing money and on-lending it to unrelated parties.

They would be unfairly penalised if a full interest deduction was not allowed for borrowings used for this purpose. Westpac is subject to the thin capitalisation rules.

[237] Dividends derived by a New Zealand resident company from a CFC are exempt income: s CB 10(1). However, those dividends (including dividends from grey list CFCs) can be subject to domestic withholding payments (DWP) on receipt by the New Zealand resident company: subpart NH. DWP is a mechanism for collecting tax payable on the foreign sourced dividends by the New Zealand resident company's underlying non-corporate shareholders. This tax would not otherwise be paid until the New Zealand resident company itself paid a dividend to the shareholders. By this means, DWP prevents deferral of tax through retention of the foreign sourced dividends within the New Zealand resident company. At the relevant times the DWP rate was 33%.

[238] The conduit tax rules applied to income earned by Westpac from Koch in the following ways: (1) TBNZI and its immediate shareholder TBNZ Developments made the requisite tax elections and maintained the necessary conduit tax relief accounts; (2) as Kiwi was resident and liable to tax in the United States (a grey list jurisdiction), TBNZI did not derive any attributed foreign income under the CFC rules and TBNZI did not claim conduit tax relief for attributed CFC income; (3) TBNZI declared that it derived the Kiwi dividends but noted that it was a conduit tax relief company and claimed that relief from DWP on the dividends; and (4) as a result of the on-lending concession, both debt and assets of the New Zealand group were reduced by the value of financial arrangements such as loans under which Westpac group members provided funds to non associated parties at an arm's length interest rate.

Foreign Tax Credit Regime: CSFB

[239] Westpac returned income on the CSFB transaction under the foreign tax credit rules. Section LC 1(1) provides:

> Where a person who is resident in New Zealand derives gross income from a country or territory outside New Zealand, income tax paid in that country

> or territory in respect of that income shall be allowed as a credit against the income tax liability of the person.

[240] The purpose of the foreign tax credit rules is to provide a credit for foreign taxes paid by New Zealand taxpayers, thereby avoiding double taxation. The regime operates on the understanding that overseas jurisdictions reciprocate by providing their taxpayers with a credit for tax paid in New Zealand. The credit available to the New Zealand taxpayer is limited to the lesser of either the foreign tax paid on the particular income or the New Zealand tax payable on that income in the absence of a foreign tax credit: ss LC 2 and LC 14.

[241] A source approach is adopted for calculating the New Zealand tax payable on each amount of foreign sourced income of a particular source or nature. Each amount of foreign sourced income of a particular source or nature is reduced by deductions fairly attributable to it. The reduced amount is then divided by the taxpayer's total net income (from domestic and foreign sources) to produce a percentage. The foreign tax credit claimable against New Zealand tax on the particular foreign sourced income is a corresponding percentage of a taxpayer's notional income tax liability.

[242] The foreign tax credit rules applied to income earned by Westpac from CSFB as follows: (1) as a partner holding the A Partnership interests in the Madison Park Partnership, TBNZI UK derived approximately 99.5% of the income of the partnership, consisting of interest on the loan note issued to CSFB, and paid United States federal income tax on its interest in the partnership at 35%; (2) in its relevant tax returns TBNZI UK declared as gross income its interest in the income of the partnership and claimed a credit for United States federal income tax paid on that income against its New Zealand tax liability: s LC 1 (as the US federal income tax paid at 35% exceeded TBNZI UK's New Zealand income liability at 33% on the partnership income, no New Zealand income tax was payable); (3) there was no limitation on TBNZI UK's foreign tax credits because the company had neither other sources of gross income nor material deductible expenditure: s LC 2 and LC 14; and (4) neither TBNZI UK (or any other person) received a refund or repayment of the US federal income tax or another amount: s LC 1(3A) – there was no disallowance of TBNZI UK's foreign tax credits.

Deductibility of funding costs and other interest expenditure

[243] The ITA incorporated nexus requirements for the deductibility of interest by companies until the 1997/1998 income year. Previously, to become deductible, interest needed to be payable in deriving the taxpayer's gross income; in carrying on a business for the purpose of deriving that income; or by one company included in a 66% commonly owned group of companies for monies borrowed to acquire shares in another company included in that group: s DD 1(b). The interest deductibility rules were supplemented with the new s DD 1(3) in 2001 with retrospective effect to the beginning of the 1997/1998 income year. Subject to limited exceptions, and to the thin capitalisation regime, expenditure by a company on interest is an allowable deduction as of right.

[244] However, automatic interest deductibility under s DD 1(3) does not apply to companies that themselves derive income, or are in the same wholly owned group as a company which derives exempt income, in each case being exempt income other than dividends. This right to automatic interest deductibility where a company derives exempt dividends is reinforced by s BD 2A, which provides:

> Despite s BD 2(2)(b) [the general prohibition in the IT Act against claiming deductions for expenditure incurred in deriving exempt income], a company's expenditure on interest may be an allowable deduction under s DD 1(3).

[245] For the purposes of s DD 1(3) 'interest' includes expenditure incurred under subpart EH; that is, the expenditure under a 'financial arrangement' subject to division 1 or 2 of the financial arrangements regime (the accrual rules): s DD 1(4). A financial arrangement is broadly any arrangement (including a debt) under which a person receives money in consideration for a person providing money to any person at a future time, or when a future event occurs. Westpac says that the concept includes a loan, a swap, a guarantee and all collateral arrangements but excludes shares and other equity instruments; and that fixed rate shares are equity, not financial arrangements.

[246] Mr Green submits that ss DD 1(3) and (4) show the legislature's clear appreciation of the principle that taxpayers could deduct interest against other

income when deriving exempt dividends; and both sections specifically recognise and endorse the concept of asymmetry.

[247] Any income from a financial arrangement is assessable and any expenditure is deemed to be interest expenditure; as such, financial arrangement expenditure by companies (including ordinary interest, net swap expenditure and guarantee fees) is generally automatically deductible under s DD 1(3).

[248] Subject to one important contest, the interest deductibility rules applied to Koch as follows:

(1) Any and all interest expenditure incurred by WBC or any other member of the Westpac group was fully and automatically deductible: s DD 1(3);

(2) All other net expenditure of Westpac group members under financial arrangements including swap losses and the GPF (which the Commissioner disputes) was deemed interest expenditure: s DD 1(4). Accordingly, it was automatically deductible: s DD 1(3);

(3) As the debt to asset percentage of the Westpac NZ group was at all relevant times less than 75%, the thin capitalisation rules did not reduce any Westpac group members allowable interest deductions.

[249] Mr Green says that swaps are treated for tax purposes on a composite basis, with net income/loss calculated under the financial arrangement rules. A taxpayer which is a party to an interest rate or currency and interest rate swap must recognise and spread income/expenditure under the swap in compliance with determination G27 (a financial arrangement's determination made by the Commissioner under s 90 Tax Administration Act 1994). Two legs of such a swap are treated together as a composite arrangement. Only the net position is reported (as income or expenditure) for income tax purposes. Mr Green says it is inherent in the mutual nature of the swap that a person's expenditure under it is necessarily connected to its income.

[250] On Koch (see diagram at [148]):

(1) TBNZI calculated (under subpart EH and determination G27) for each income year the net of the fixed and floating legs of the internal swap with WBC. In all relevant income years the fixed payments of 6.815% per annum on NZD390m by TBNZI to WBC exceeded the floating (NZD BBR) payments on NZD390m by WBC to TBNZI. Thus TBNZI incurred net expenditure under subpart EH, claimed as an interest deduction under s DD 1(3);

(2) WBC calculated (under subpart EH and determination G27) for each income year the net of the fixed and floating legs of the internal swap with TBNZI. Conversely to (1) above, in all relevant income years WBC had net income under subpart EH (equal to TBNZI's corresponding net expenditure) which it included as gross income;

(3) WBC calculated (under subpart EH and determination G27) for each income year the net of the fixed and floating legs of the basis swap with KCS. In all relevant income years the fixed payments of 6.815% per annum on NZD390m by WBC to KCS exceeded the floating (USD LIBOR) payments on USD200m by KCS to WBC, meaning WBC incurred net expenditure under subpart EH which it claimed as an interest deduction : s DD 1(3).

[251] Subject to the Commissioner's challenge to (2) below, the tax features of Koch were as follows:

(1) Dividends derived by TBNZ Investments on the preference shares were exempt income: s CB 10(1); and were relieved from dividend withholding payment under the conduit rules;

(2) Westpac claims, and the Commissioner denies, that the GPF paid by TBNZ to KCS for its parent's guarantee was an allowable deduction: s BD 2(1)(b)(i)-(ii) (being both deemed interest expenditure (subpart

EH) and accordingly deductible (s DD 1(3)) and also expenditure incurred by TBNZ in deriving its gross income in or carrying on a business for the purpose of deriving its gross income);

(3) Any loss by TBNZ or WBC on the internal swap was deductible: s BD 2(1)(b)(iii) (as deemed interest expenditure (subpart EH), deductible under s DD 1(3). An equivalent amount to any such loss on the internal swap was gross income for the other party;

(4) Any loss by WBC on the basis or currency swap with the counterparty was an allowable deduction for it: s BD 2(1)(b)(iii) (as deemed expenditure (subpart EH) deductible under s DD 1(3)). Any gain would be gross income for WBC;

(5) TBNZ's overall net loss (its gross income, if any, less its allowable deductions for the guarantee procurement fee and the loss on the internal swap) was able to be offset against WBC's net income under the group loss offset provisions: subpart IG;

(6) Any other interest expenditure incurred by WBC, or any other member of the Westpac group, was fully and automatically deductible: ss BD 2(1)(b)(iii) and DD 1(3).

Guarantee Procurement Fee

[252] Westpac paid GPFs totalling about NZD556m (resulting in tax benefits of about NZD176m) on the nine transactions. The bank submits that TBNZI's payment of a GPF to KCS on Koch gave rise to net expenditure under a financial arrangement (subpart EH). Thus the fee was interest automatically deductible: s DD 1(3). Mr Green points to the Commissioner's acceptance of this proposition when giving the First Data ruling; the Commissioner now contends to the contrary. Alternatively, Mr Green submits that the GPF had a nexus with the derivation of gross income and was thus deductible: s BD 2(1)(b)(i) or (ii).

[253] The same issue arose in *BNZ Investments (No 2)*. Wild J found for the bank on its primary argument for deductibility which is materially the same as Westpac's: at [151]-[156]. Nevertheless, the Commissioner remains free to challenge Westpac's claim, albeit by relying on the same grounds on which he failed in the *BNZ Investments (No 2)* case.

(1) Financial Arrangement

[254] The first question is whether the GPF was paid under a 'financial arrangement'. Westpac entered into Koch and First Data prior to 20 May 1999. A 'financial arrangement' was then defined by subpart EH as follows:

> (a) any debt or debt instrument, and
>
> (b) any arrangement (whether or not such arrangement includes an arrangement that is a debt or debt instrument, or an excepted financial arrangement) **whereby a person obtains money in consideration for a promise by any person to provide money to any person at some future time or times**, or upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice), and
>
> (c) any arrangement which is of a substantially similar nature (including, without restricting the generality of the preceding provisions of this subparagraph, sell-back and buy-back arrangements, debt defeasances, and assignments of income),
>
> but does not include any excepted financial arrangement that is not part of a financial arrangement.
>
> [Emphasis added]

[255] This definition was amended on 20 May 1999. All other transactions were entered into subsequently. The amended definition of a 'financial arrangement' is in the accrual rules in Division 2 EH 22(1) as follows:

> (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** …
>
> (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).
>
> [Emphasis added]

[256] Westpac apparently believed that a guarantee fee might have been caught by s CN 4 and subject to liability for withholding tax. That section provided:

> (1) Where—
>
> (a) Any insurer derives a premium which is, under section OE 4(1)(o), income deemed to be derived from New Zealand; and
>
> (b) At the time the insurer derives the premium, the insurer is not resident in New Zealand; and
>
> (c) The premium is not attributable to any fixed establishment of the insurer in New Zealand through which the insurer carries on business in New Zealand,—
>
> the insurer shall be deemed to have derived from that premium taxable income equal to 10% of the gross amount of the premium, and income tax shall be assessed and levied on that taxable income at the rate of income tax for companies not deemed to be resident in New Zealand, expressed as a percentage, stated in clause 6 of Part A of Schedule 1.
>
> …
>
> (6) In this section, the 'insurer' includes any person named in a contract of insurance as liable, or who otherwise incurs liability under a contract of insurance, to pay or contribute towards payment in whole or in part of any amount that may become claimable by the person insured under the contract.

[257] The ambit of s CN 4 was clarified by s CN 5(2) which defined a 'contract of insurance' as including:

> A policy of insurance, an insurance cover and a renewal of a contract of insurance.

The word 'insurance' was defined as:

> Insurance or guarantee against loss, damage, of any kind whatever except life insurance.

[258] Mr Green confirms that the parties adopted the GPF structure to avoid s CN 4's application. He says, however, that the GPF has the same economic effect as a guarantee fee; and that the 'payment is really for the guarantee'.

[259] Mr Green submits also that the definition of 'financial arrangement' was deliberately wide; and that its intention was to include arrangements of this very

nature. He refers to the IRD's December 1997 Policy Advice Division's document titled '*The Taxation of Financial Arrangements*' which states: at 13.1:

> A guarantee or other security arrangement for which a fee is paid to the guarantor will fall squarely within the definition of a financial arrangement adopted by the accrual rules.

[260] Mr Green's primary submission is that:

> **In fact, all but a small proportion of the fee was payable in consideration for the KII guarantee itself**. The term 'procurement' conveys the concept that the fee was payable to a person (KCS) other then the guarantor (KII). [TBNZI's] agreement to pay the GPF was necessary consideration for the KII guarantee. As a matter of contract, [TBNZI's] entry into the GPF agreement was a condition precedent (of KCS) to the forward transfer agreement and other transaction agreements becoming effective. Similarly, KII's execution of the KII guarantee was a condition precedent (of [TBNZI]) to the forward transfer agreement and other agreements becoming effective. Accordingly, [TBNZI] needed to enter into the GPF agreement, and in doing so agree to pay the GPF, in order that its exposure to KCS, undertaken by entering into the forward transfer agreement, would be secured by the KII guarantee.
>
> [Emphasis added]

[261] In support Mr Green cites *Buckley & Young Ltd v Commissioner of Inland Revenue* [1978] 2 NZLR 485 (CA) per Richardson J at 490:

> A deed or other instrument must be construed as a whole and, if the transaction is embodied in a number or complex of interrelated agreements, then all the agreements must be considered together and one may be read to explain the others.

[262] I must determine the question of whether the GPF was paid under a financial arrangement and was thus within the statutory definition of deductible interest according to *Ben Nevis* as follows (to the identical effect, see Richardson J in *Buckley & Young* at 489-490):

> [47] In proceeding in this way, the Court must also respect the fact that frequently in commerce there are different means of producing the same economic outcome which have different tax consequences. When considering the application of a specific tax provision, before reaching any question of avoidance, **the Court is concerned primarily with the legal structures and obligations the parties have created and not with conducting an analysis in terms of their economic substance and consequences, or of alternative means that were available for achieving the substantive result.**

> [48] On the other hand, it is the true meaning of all provisions in a contract that will determine the character of a transaction rather than the label given to it. The label "licence premium" is accordingly not what is important in the present case, **but rather the true contractual nature of the legal rights for which payment is to be made and the effect of applying the tax legislation to a payment of that character**. Once the nature of the contractual rights and obligations has been determined in this way, the specific provision can be applied.
>
> [Emphasis added]

[263] What then is the true contractual nature of the legal right for which the GPF was paid, viewed not in terms of economic substance but within the legal structures and obligations created by the parties?

[264] The GPF agreement between TBNZI and KCS operatively provided, at clause 2.2:

> **Guarantee Procurement fee.** The Investor shall pay to Koch Affiliate *in consideration of Koch Affiliate procuring the issue and continuation of the Koch Industries Guarantee a fee* (the 'Guarantee Procurement Fee'), such fee to be calculated on the basis of actual days elapsed and a 365-day year and paid in arrears on each Payment Date with the first of such payments being due on the Payment Date which immediately succeeds the Closing Date, provided that if the Issuer should make an Interim Payment, a portion of the Quarterly Guarantee Procurement Fee equal to the proportion that the Interim payment bears to the Distribution Amount for such payment period shall be immediately due and payable. **The Guarantee Procurement Fee shall be calculated on the basis of 2.85% per annum of the Transfer Price** (as the Transfer Price may be reduced by partial exercise of the Forward Transfer Agreement under Section 4 thereof).
>
> [Emphasis added]

[265] By this provision the contractual consideration for the fee was expressly limited to KCS's composite act in procuring KII's guarantee and its continuation. The GPF was payable for that service and that service alone. The GPF was not paid in consideration for a promise 'by [KCS or KII] to provide money': subpart EH(b).

[266] It must be inferred, for the purpose of this inquiry, that the parties deliberately structured their payment rights and obligations as a genuine record of their mutual intentions. If the true position was otherwise, Westpac would have been at risk of the Commissioner's revival of his discontinued allegation of sham: compare *Ben Nevis* at [33].

[267] KII's deed of guarantee was the only other directly relevant contractual instrument within the *Buckley & Young* test. The deed began by reciting that its execution was a condition precedent to two other contractual documents. But it made no reference to the GPF agreement. Its terms were absolute and unconditional in guaranteeing performance of KCS's obligations. Given its status as a deed, the guarantee omitted reference to the requirement for consideration, acknowledging simply that it was enforceable by TBNZI, Westpac and any other member of the group enjoying the benefit of obligations owed under the forward sale agreement. Thus I cannot accept Mr Green's proposition that TBNZI's agreement to pay the GPF to KCS 'was necessary consideration for the KII guarantee'.

[268] The two primary documents created an unambiguous legal structure. By virtue of the GPF agreement, TBNZI agreed to pay a fixed fee; in consideration, KCS agreed to procure and maintain KII's guarantee. That was the legal right for which the GPF was paid, and which TBNZI was entitled to enforce against KCS. The deed of guarantee, which TBNZI was also entitled to enforce but separately against KII, was evidence of itself of KCS's performance of its obligations.

[269] In combination, the GPF and KII's guarantee speak for themselves in rejection of Mr Green's primary submission that 'all but a small proportion of the fee was payable in consideration for the KII guarantee itself' and its variant that 'payment [was] really for the guarantee'. The parties expressly agreed that TBNZI would pay the GPF of 2.85% of the transfer price. In contractual terms the fee was either a guarantee procurement fee payable to KCS or a guarantee fee payable to KII; it was one or the other, and there could be no halfway house. In the event of a default in payment by TBNZI, KCS would have been entitled to sue for the full amount payable. But KII would not have had a right of recovery.

[270] Nevertheless, Mr Green submits that TBNZI's liability to pay the GPF to a party other than the guarantor is irrelevant to the question of whether the fee was consideration for the guarantee itself. He says that consideration for a guarantee can flow from the creditor either to the guarantor or to the principal debtor with the guarantor's assent. Mr Green submits the consideration for this guarantee flowed from the creditor, Westpac, to the principal debtor, KCS, as an inducement to the

guarantor, KII, to agree to provide its guarantee. In this way, he is effectively saying that KII was the person which 'obtain[ed] money [from Westpac] in consideration for [its] promise' to pay money in the future in terms of subpart EH.

[271] Mr Green relies on two authorities. The first, *Halsbury's Laws of England*, 5th Ed., Vol. 49 states at para 1048:

> The consideration for the guarantor's promise does not move from the principal debtor, but from the creditor. It need not directly benefit the guarantor, although it may do so, and it may consist wholly of some advantage given to or conferred on the principal debtor by the creditor at the guarantor's request. Thus, the guarantor's promise often stipulates for a supply of goods or an advance of money to the principal debtor, or that the principal debtor should be taken into the creditor's service or employment.

[272] However, this statement of general principle was made in a different context and for a different purpose. *Halsbury* was discussing the necessity for and requisites of consideration under a guarantee within the relationship between guarantor and creditor, starting from the orthodox premise that a guarantee made by deed does not require proof of consideration. By contrast, a guarantee constituted by contract must be supported by consideration, which moves from the creditor, not the principal debtor.

[273] KII's guarantee was given to Westpac under deed. The guarantee was enforceable by Westpac without proof of consideration. Neither the guarantee's status nor the existence of consideration passing between KII and Westpac is in contest in this litigation.

[274] Moreover, an inference cannot be drawn from the contracts that KII assented to a proposition that consideration for its guarantee was either required or was to be paid to KCS. Similarly, an inference cannot be drawn from the contracts that the GPF was to be paid as an inducement to KII to provide the guarantee. The GPF agreement, I repeat, recited that payment of the fee was in consideration for a different service.

[275] Mr Green's second authority is Best CJ's statement in *Morley v Boothby* (1825) 130 ER 455 at 457 that:

> No court of common law has ever said that there should be a consideration directly between the persons giving and receiving the guaranty. It is enough if the person for whom the guarantor becomes surety has benefit, or the person to whom the guaranty is given suffers inconvenience, as an inducement to the surety to become guarantor for the principal debtor.

This statement simply stands as authority for the first sentence in *Halsbury's* at para 1048, but takes Westpac's case no further.

[276] Finally, Mr Green relies on this statement from *The New Zealand Accrual Regime* at 202:

> Secondly, the promise to provide money can be made by any person to any person. It need not be made by the person who obtained money in the first place, nor need it be a promise to pay money to the person who initially provided money. Under a conventional loan, the person obtaining money in the first place would be the borrower. In consideration for that loan, the borrower would promise to provide money to the lender. However, the wording of this part of the "financial arrangement" definition is specifically designed to cover more complex arrangements; for example, it covers the situation where A lends money to B, in consideration for which C makes payments to D. Here, a third party, C, makes payments to a fourth party, D, with respect to a "loan" provided by A to B. In other words, the "financial arrangement" definition cannot be avoided by inserting different parties into a transaction. The wording of this part of the definition was not solely anti-avoidance motivated. It also ensured that complex commercial transactions, such as debt defeasances and assignments of income, are "financial arrangements".

[277] I have not found this statement germane to the question of whether or not a financial arrangement existed here. It explains how the provision could be construed to extend the meaning of a 'financial arrangement" to instruments such as debt defeasances and assignments of income. Those situations are far removed from this case where the result is to be determined according to the contractual provisions employed by the parties.

[278] On analysis, Mr Green's argument relies solely on eschewing legal form in favour of economic substance or consequences, contrary to *Ben Nevis* at [47] and [48] and *Buckley & Young* at 489-490. If its objective was to accommodate economic substance within a legal framework, Westpac was bound to establish that, despite the unequivocal terms of the GPF agreement, most of the fee was in truth payable in consideration for something else.

[279] Apart from exposing itself to a revival of the Commissioner's sham defence and such an argument's inconsistency with orthodox contractual theory, the bank would have had to (a) prove Mr Green's submission that 'only a small proportion' of the GPF was payable in consideration of KCS's promise to procure KII's guarantee and (b) quantify the amount actually apportioned. Mr Gibbs himself acknowledged that, while KCS's procurement task was not 'substantial', it was still worth something. But neither he nor any witness attempted a quantification.

[280] Westpac would have had to satisfy a strict threshold test of admissibility even if it had led parol evidence for this debatable purpose of quantifying an apportionment between the services of procuring and providing a guarantee. In *Pao On v Lau Yiu Long* [1980] AC 614 (applied in *Laing v Lanron Shelf Co No 56 Ltd* [1994] 1 NZLR 562 at 570-571), Lord Scarman described the prerequisites of the test as follows at 631:

> There is no doubt – and it was not challenged – that extrinsic evidence is admissible to prove the real consideration where (a) no consideration, or a nominal consideration, is expressed in the instrument , or (b) the expressed consideration is in general terms or ambiguously stated, or (c) a substantial consideration is stated, but an additional consideration exists. The additional consideration must not, however, be inconsistent with the terms of the written instrument. Extrinsic evidence is also admissible to prove the illegality of the consideration.

[281] In explanation of the third of these three categories (the only one possibly available to Westpac), the Privy Council had earlier in *Frith v Frith* [1906] AC 254 at 259 cited with approval this passage from *Clifford v Turrell* Y&C Ch 138:

> Rules of law may exclude parol evidence where a written instrument stands in competition with it, but it has long been settled that it is not within any rule of this nature to adduce evidence of a consideration additional to what is stated in a written instrument. The rule is that where there is one consideration stated in a deed you may prove any other consideration which existed, **not in contradiction to the instrument**; and it is not in contradiction to the instrument to prove a larger consideration than that which is stated.
>
> [Emphasis added]

[282] The rationale for this rule seems clear. Subject to narrow and well settled exceptions, a party cannot challenge or undermine what is written. In the event of a dispute, a party can only prove that consideration moved, additional to but not in

conflict with that stated, which gives rise of course to different contractual consequences.

[283] So, for example, the question in *Laing* was whether the plaintiff was entitled to specific performance of an agreement for sale and purchase of real property. He contended that the 'true consideration' for its transfer was the continuation of development work which had been carried out, not its stated consideration of provision of consultancy services which had not been performed. Gallen J was satisfied that the real consideration for the agreement was as the plaintiff alleged. But, given its inconsistency with the stated consideration, the parol evidence rule applied to exclude evidence of it.

[284] Westpac's case did not attempt to satisfy this third category. And nor could it, because the exception would require the bank to prove additional consideration consistent with the contractual documents whereas Mr Green's argument proceeded on the premise of substantive inconsistency. The acts of procuring and providing a guarantee were different in nature and concept; and the two services emanated from different parties, giving rise to different rights of recourse. In any event, parol evidence of the parties' intentions at the time of contracting is entirely consistent with the written agreements.

[285] In closing Mr Farmer introduced a gloss or variation on Mr Green's argument. It arose during Mr Farmer's submissions on avoidance. His argument is to this effect: while the fee was called a GPF, which it was in law and in substance, the parties regarded its benefit as the delivery of KII's guarantee. The fee's consideration was KCS's promise to obtain its parent's guarantee. What Westpac received in return was the service of procurement and provision of the guarantee. Both elements constituted the contractual benefit (and by implication the consideration) accruing upon performance of KCS's promise. In Mr Farmer's words, it is 'very hard to separate out' those two elements.

[286] Mr Farmer illustrates his proposition with an analogy. He cites the example of a property owner who contracts with a builder to provide a range of services. Among them is the engagement of a plumber whose work will comprise 90% of the

contracted services. The builder pays 90% of the contract price to the plumber accordingly. In that case, Mr Farmer says, the builder's consideration for the owner's payment is largely delivery of the plumber's services. His example of the builder and plumber is apparently designed to equate roughly with the division of services performed by the procurer and the guarantor.

[287] Mr Farmer's use of the building analogy does, I think, largely answer his own proposition. In his example the owner pays the price to the builder for provision of all services including the plumbing. But those services are normally specified within the scope of work to be performed under the head contract and the price is allocated to each item of work, justifying the 90% which the builder will pay the plumber. The contract specifies the division. The owner has no contractual recourse against the plumber; he or she can only look to the builder, the other contracting party, for performance. And the plumber has no contractual liability to the owner. That factual example does not provide a helpful analogy given that the circumstances of each case will depend upon the relevant contractual framework.

[288] On analysis, Mr Farmer's argument is little different from the essence of Mr Green's proposition. It must fail on the same grounds. Mr Farmer concedes that the consideration for the fee was KCS's promise to obtain its parent's guarantee. The fact that Westpac obtained the benefit of that promise on delivery of the guarantee is not in contest and does not advance its case when determining the application of subpart EH and whether the GPF was a 'financial arrangement'.

[289] It is unnecessary to embark upon Mr Farmer's 'very hard' exercise of attempting to separate KCS's promise to procure from KII delivery of the guarantee. He does not, for obvious reasons, propound a concept of indivisibility of services. Instead he propounds, under a different conceptual guise, Mr Green's argument of apportionment of consideration but without laying the necessary legal or evidential foundation.

[290] However, the fact remains, as the GPF agreement provides, that the fee was provided solely in consideration for KCS's promise to procure and maintain a guarantee. On Mr Farmer's own admission of the constitution of the consideration

in this case, KCS did not ‘obtain money [the GPF] in consideration for a promise by [KII] to provide money to [TBNZI]’.

[291] I accept that in contractual terms the deed of guarantee is the natural or necessary consequence of KCS’s performance of its contractual obligation. But while delivery of the guarantee is inherent in KCS’s promise to procure, the contractual structure makes plain the parties’ agreement that Westpac was required to pay only for the service of procurement, not for the guarantee itself. If the position was otherwise, it was open to the parties to agree on a specific guarantee fee. And, even if Mr Farmer is correct that the parties regarded the delivery of the KII guarantee as Westpac’s benefit derived from payment of the fee, that feature does not change the essential contractual characteristic of payment of the fee for the promise to procure. Unlike his plumber example, the consideration was expressly identified in this case.

[292] In summary, I am satisfied that the GPF agreement accurately records the parties’ bargain. Westpac and KCS deliberately chose to structure their arrangement according to its terms. The documents must be interpreted according to their contractual nature and effect. Westpac cannot defeat the legal consequences by resorting to an argument of economic substance because the result is now unsuitable.

[293] In terms of subpart EH, the GPF agreement was not a ‘financial arrangement’. KCS did not ‘obtain money [the GPF] in consideration for a promise by [KII] to provide money to [TBNZI]’. KCS obtained the money in consideration for its promise to procure and maintain its parent’s guarantee. However widely the provision is construed, it does not include payment of the GPF.

[294] I should add, for completeness, Mr Green’s acceptance that the amended definition of ‘financial arrangement’, which was in force for all transactions except Koch and First Data, did not provide a materially different test. That amendment substituted ‘a person receiv[ing] money’ for ‘a person obtain[ing] money’. But the critical requirement of ‘in consideration’ remained.

[295] I am conscious that I am differing from Wild J's conclusion in *BNZ Investments (No 2)* but I can only assume that the deductibility issue has assumed greater importance in this case.

(2) Derivation of Gross Income

[296] Westpac argues alternatively that the GPF is deductible because it was incurred in deriving gross income. Wild J rejected a similar argument which was run by the taxpayer in *BNZ Investments (No 2)*: at [162]-[172]. However, given that the Judge had already upheld the bank's primary argument on deductibility, this part of his judgment was strictly obiter. Again I will have to consider the arguments afresh.

[297] Mr Green submits that the GPF is deductible under s BD 2(1)(b)(i) and (ii) which materially provided as follows:

> (1) An amount is an allowable deduction of a taxpayer…
>
> (b) to the extent that it is an expenditure or loss
>
> (i) incurred by the taxpayer in deriving the taxpayer's gross income, or
>
> (ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income…

[298] However, s BD 2(2) expressly provided that:

> An amount of expenditure or loss is not an allowable deduction of a taxpayer to the extent that it is:
>
> (a) of a private or domestic nature, or
>
> (b) incurred in deriving exempt income under Part C (Income Further Defined), D (Deductions Further Defined) or F (Apportionment and Recharacterised Transactions) …
>
> (e) of a capital nature, unless allowed as a deduction under Part D (Deductions Further Defined) or E (Timing of Income and Deductions) …

[299] To succeed under s BD 2(1)(b)(i) or (ii), Westpac must prove a nexus between the deduction claimed for interest and the derivation of gross income (in

contrast to interest (or deemed interest) under s DD 1(3)). Here, Mr Green submits, TBNZI held the Kiwi preference shares on revenue rather than capital account; that is, receipts from its disposal of the shares were gross income on either of the alternative bases.

[300] The first of Mr Green's alternatives is to this effect: as a member of a wholly owned group of companies engaged in the banking business, TBNZI's securities held for investment purposes are revenue account assets and their disposal generates income from a business: s CD 3. The fact that the GPF was incurred by TBNZI to obtain security relating to risk associated with the sale of its revenue account assets is sufficient of itself to establish the required nexus – that is, TBNZI necessarily incurred the GPF in deriving gross income, the forward transfer price, or in the course of carrying on a business for the purpose of deriving its gross income. If the KII guarantee was called upon, any receipt by TBNZI would replace gross income and would itself be classified as gross income – again the required nexus with contingent gross income exists.

[301] Mr Green also notes that the Commissioner, in his Issues Report dated 12 October 2000, concluded that the preference shares in the First Data issuer were held by TBNZ on revenue account by virtue of its rights and obligations under the forward transfer agreement. By contrast, in his NOPA issued to TBNZI on 30 March 2005 at para 71, the Commissioner was of the opinion that the GPF had a:

> … nexus with the production of exempt income [i.e. the Kiwi preference share dividends], disqualifying the expenditure from deduction under s BD 2(2)(b).

[302] Determination of Westpac's argument is primarily a factual exercise. It is necessary to cite only one authority. In *Waylee Investments Ltd v Commissioner of Inland Revenue (Hong Kong)* [1990] BTC 543 the Privy Council considered the factual converse to this case. The taxpayer, a bank subsidiary, was formed to buy new shares in a customer which was in financial difficulties and heavily indebted to the bank. By this means the latter acquired effective control of the former. The bank subsidiary bought the shares and sold them four years later.

[303] On appeal in *Waylee* the question was this: Did the substantial profit earned on disposition of the shares arise from the sale of a capital asset, as the taxpayer contended? Or did the acquisition and disposal of the shares amount to a concern in the nature of trade, as the Commissioner argued? In allowing the taxpayer's appeal, the Privy Council said this per Lord Bridge at 547-548:

> Many authorities have been referred to in the course of argument, but it has to be recognised that the law has never succeeded in establishing precise rules which can be applied to all situations to distinguish between trading stock and capital assets. The stock in trade of a bank is money and securities readily convertible into money. But it is equally clear that a bank, like any other trader, may hold investments as capital assets. The clearest indication that an investment was acquired as a capital asset would be an indication that the bank intended to hold the investment as such for an indefinite period. The clearest indication that an investment was acquired as trading stock would be an indication that it was held by the bank as available to meet the demands of depositors whenever necessary. But the indications to show to which category a particular investment belongs may be uncertain, inconclusive or even conflicting.
>
> Here, if one asks whether the bank ever intended that the HIL shares should be held as part of the bank's circulating assets available to meet depositors' demands, the answer must surely be no. An essential feature of the rescue operation was that the bank should be seen to have confidence in HIL. Resort to the shares as part of the bank's stock in trade would have been entirely inimical to this purpose. Moreover, the decision that the shares should be held by the taxpayer, in accordance with the bank's unchallenged policy in respect of its long-term investments, demonstrates, quite apart from any technical issue arising from the taxpayer's separate legal identity, that the bank never intended to treat the shares as, in this sense, part of the bank's stock in trade.

[304] In my judgment, applying the *Waylee* test, all the evidence points to the conclusion that TBNZI acquired and held the Kiwi shares as capital assets. The shares were not in the nature of a bank's traditional stock in trade – money and securities readily convertible into money. TBNZI was contractually barred from trading in the shares, even if KCS defaulted under the forward transfer agreement. They were to be held for a term of five years subject to rights of early termination.

[305] It is clear, I think, that the Kiwi preference shares were not held on revenue account; and that the GPF expenditure was incurred in acquiring capital assets (the proceeds of sale did not, for the reason I am about to give, constitute the bank's gross income). As in *Waylee*, the shares were not held by the bank, but by a separate legal entity formed for the purpose of acquiring and holding them for a fixed term; nor

were the shares available to meet the demands of Westpac's depositors whenever necessary. The bank has failed to establish the necessary nexus between the GPF expenditure and its receipt of gross income.

[306] Mr Green's second alternative argument is that TBNZI acquired the Kiwi preference shares for the purpose of sale or other disposition given its obligation to resell them to KCS under the forward transfer agreement. Section CD 4 provides:

> The gross income of any person includes, any amount derived from the sale or other disposition of any personal property or any interest in personal property (not being property or any interest in property which consists of land), if the business of the person comprises dealing in such property or if the property was acquired **for the purpose of selling or otherwise disposing of it** …
>
> [Emphasis added]

[307] Without doubt, Westpac intended to sell the Kiwi shares. It purchased them subject to that obligation. However, I agree with Mr Brown that its intention is not necessarily synonymous with 'acquisition for the purpose of selling'. In terms of s CD 4, the inquiry must always be whether the taxpayer acquired the property for the purpose of achieving a profit or gain by means of resale or other disposition.

[308] In *Commissioner of Inland Revenue v National Distributors* (1989) 11 NZTC 6,346 (CA), the Court of Appeal considered this question of whether, in terms of the predecessor to s CD 4, 'property was acquired for the purpose of selling or otherwise disposing of it'. Richardson J said this at 6,350-6,352 (citations omitted):

> Profits derived from the sales of shares [are] taxable under the second limb if the shares were acquired for the purpose of sale. It is well settled that the test of purpose is subjective requiring consideration of the state of mind of the purchaser as at the time of acquisition of the property… Where there is more than one purpose present taxability turns on whether the dominant purpose was one of sale or other disposition… Adoption of a dominant purpose test in relation to the particular property purchased allows a sensible focus as a practical matter on what was truly important to the taxpayer at the time of acquisition… It is still necessary to determine whether the dominant purpose of the taxpayer in acquiring the property was to sell it at a future date… [T]he reason why the taxpayer decided to buy with a view to selling in due course is not relevant to the statutory inquiry. If the taxpayer's dominant purpose in acquiring the property is to sell it in the future at a price which, allowing for inflation, corresponds with or is better than its price at the time of purchase, his statutory purpose is to sell the property even though his motive is to protect his savings from inflation… A person

> buying [shares] does so either with a view to investment for the income it will return, or with a view to realising a profit on disposal sooner or later – and while logically the purposes of retention or resale are not mutually exclusive, it will generally be possible to say that one or the other is predominant at the time when the purchase is made … [For the provision to apply] the dominant purpose of the purchaser must have been the resale of the property. If the investment policy is to provide and enlarge the dividend income and to buy (and sell) with that as the dominant consideration, there can be no basis for invoking the second limb.

[309] Only one inference is available from the totality of the evidence. The predominant, indeed sole, purpose of TBNZI's acquisition of Kiwi's preference shares was to derive a dividend flow. Mr Green did not identify anything to the contrary. It is unnecessary to recite the exchanges between Westpac and the counterparty focusing on fixing the dividend rate.

[310] Westpac's acquisition of Kiwi's shares was the means of securing the income stream available from the distributions. Significantly, also, the resale price was the same as the transfer price – it is the antithesis of acquisition for the predominant purpose of sale or disposition to buy shares for resale at no profit. Accordingly, because TBNZI did not acquire the shares 'for the purpose of selling', the net proceeds of disposition were capital assets, not revenue items.

[311] Mr Green advances a subsidiary argument within his second alternative. He says that the required nexus between expenditure and gross income is established for this reason; if the guarantees were called upon, the proceeds would be gross income because they would be received in substitution for the price payable under the forward transfer agreement. However, given my conclusion that the proceeds of sale did not constitute part of Westpac's gross income, any contingent payment under the guarantee would have the same status.

[312] In any event, there was no nexus between the GPF payment and Westpac's gross income. The nexus was, in fact, between its payment and the dividend distribution: *BNZ Investments (No 2)* at [169]. As Mr Brown submits, the documents form an integrated and interdependent set of transactions and cashflows, obliging Westpac to pay the GPF and the issuer to pay the dividend. Furthermore, an amount of expenditure is not allowed as a deduction to the extent that it is incurred in deriving exempt income: s BD 2(2)(b); it is common ground that all dividends were

exempt from tax under the relevant conduit and FTC rules: *BNZ Investments (No 2)* at [170].

[313] Also, I respectfully agree with the view of Wild J in *BNZ Investments (No 2)* at [171] that:

> Even if, contrary to the view I have just expressed, there was a nexus between the GPF and the potential payments under the guarantee, then the BNZ needed to prove the extent of that nexus, because that is also the extent of the deductibility of the GPF. The transaction documents show that payments under the guarantee would have included any outstanding distributions, which were exempt income. To the extent it "covers" those outstanding distributions, the GPF is non-deductible. The quality of those payments is not altered by their incorporation as part of the "repurchase price".

[314] Accordingly, I am satisfied that the Commissioner has correctly disallowed Westpac's deductions for the GPFs. They were not paid according to a 'financial arrangement' or in deriving gross income. In my judgment Westpac's use of the deductibility provisions was not within their ordinary meaning and scope in the light of their specific purposes.

[315] That finding is not, however, determinative of the proceeding. I must still consider Westpac's claim that, regardless of the lawfulness of its GPF deductions, the transactions are not tax avoidance arrangements and, even if they are, that the Commissioner has wrongfully reconstructed them. In fiscal terms, the consequences are potentially much greater than disallowing the bank's total deductions for GPF expenditure. On the Commissioner's case, they extend to the lawfulness of all the bank's deductions claimed for the cost of funds.

Avoidance

Introduction

[316] Of necessity, the question of whether the transactions were tax avoidance arrangements is amorphous. The Commissioner points to a number of features which individually or collectively, he says, are indicia of tax avoidance. As earlier

noted, the part played by the GPF is at the heart of what must be a wide-ranging inquiry; the findings on its permissibility will inevitably affect all other questions.

[317] Broadly stated, the question is whether by using all of the specific provisions – both the conduit and FTC regimes for income and the interest deductibility provisions for expenditure – Westpac crossed the line and changed the character of the transactions from lawful to unlawful. That inquiry will take into account:

(1) The nature of the contractual relationship between Westpac and the counterparty and the legal effects of the documents;

(2) The economic substance of the transaction (investment or loan);

(3) The structure of the transaction and whether Westpac obtained the benefit of the specific provisions in an artificial or contrived way including but not limited to:

  (a) the existence and amount of the GPF, the circumstances in which it was agreed, and its objective value – that is, whether it was at a market or commercial rate;

  (b) the use of a pricing mechanism to fix the dividend rate and in particular whether it provided for the parties to share all of Westpac's taxation benefits – that is, both cross-border and domestic asymmetries;

  (c) the cost of funds to Westpac and the profitability of the transaction (both pre and post-tax);

  (d) the relationship between a transaction and the relevant level of Westpac's tax shelter or estimated tax ratio;

  (e) the use of currency and interest swaps (both internal and external); and

(f) the financial consequences of the transaction.

[318] I will then address the parties' sole dispute about the constitution of the relevant 'arrangement' – that is, whether it included any external finance raised by Westpac to fund a transaction – before determining when the use of the relevant specific provisions is considered in the light of the commercial reality and economic effect of that use whether: (1) a purpose or effect of the transaction was to avoid liability to income tax; or (2) if one of the purposes or effects of the transaction was to avoid that liability, whether that purpose or effect was merely incidental?

(1) Contractual Relationship

[319] The nature of the underlying legal relationship between Westpac and the Koch group is not in dispute. The practical effect of the primary contractual instruments in the Koch transaction, both of transfer and security, was explained previously (at [120]-[147]). Accordingly it is only necessary to summarise the essential elements at this stage of the inquiry.

[320] At the heart of the transaction were two separate corporate structures. On one side, KII capitalised an already existing subsidiary, KCS, which in turn formed and capitalised its subsidiary, Kiwi. On the other side, Westpac used existing wholly owned subsidiaries, TBNZ and TBNZ Developments, to incorporate a special purpose vehicle, TBNZI.

[321] KCS and TBNZI were the direct contracting subsidiaries (TBNZI was formed because of a perceived risk that for US tax purposes the dividend payments would not otherwise qualify for the portfolio interest exemption from US non-resident withholding tax; that exemption required that the ultimate source of funding was neither a bank nor a conduit to a bank, and TBNZI qualified by using retained earnings rather than direct Westpac funding).

[322] There were two principal instruments under the transfer or sale agreement. KCS agreed to transfer to TBNZI preference shares in Kiwi for consideration of NZD390m. The shares were unencumbered but non-redeemable.

Contemporaneously the forward transfer agreement provided for TBNZI to sell the shares back to KCS for the same price in five years subject to TBNZI's right to sell at an earlier date on 30 days notice (full termination rights were exercisable by either party on the third and fourth anniversaries, with an option to TBNZI to resell part of the stock on each anniversary).

[323] The Kiwi shares entitled the holder to a fixed dividend rate, known as the distribution amount, of 7.7177% per annum payable quarterly. The contracts provided that a failure by Kiwi to declare a dividend for payment on the due date constituted an event of default under the forward transfer agreement. Thus, as Mr Brown points out, while the terms of the preferred stock provided that distributions were technically discretionary (for US tax purposes, otherwise the transaction would be categorised as a loan), the combined contractual effect was that Kiwi was obliged to declare a dividend of 7.7177%.

[324] The pledge agreement provided for TBNZI to deliver a security interest in the Kiwi shares in the form of a re-conveyance, which was known as the collateral. TBNZI agreed to deposit the stock ownership certificates with KCS, giving the latter a right to assume ownership of the stock upon its default.

[325] KII unconditionally guaranteed the performance of KCS's obligations under the forward transfer agreement. TBNZI agreed to pay KCS a GPF of 2.85% of the forward transfer price, and to separately pay 50% of the fee incurred by KCS on the Toronto-Dominion Bank letter of credit. That total fee was 0.25% per annum on 50% of the value of the preference shares for one year. Westpac separately guaranteed the obligations of its subsidiaries to deliver the preference shares and make payments.

[326] KCS, Kiwi and TBNZI entered into an escrow agreement, appointing KCS as escrow agent to establish an escrow fund for the benefit of all three parties. The fund was the collecting point for all interdependent payments.

[327] Mr Brown points out that the forward transfer agreement provided for termination if a 'non-default event occurs and is continuing'. That event was defined

as either a change in law having the effect of reducing the unrealised 'Expected Benefits' to a party by 15% or more, or a proposal by the New Zealand revenue authorities which put those Expected Benefits at risk. These early termination provisions were important to the Commissioner's case.

[328] The promissory note from KII to Kiwi was a promise to pay principal on demand of USD226m together with interest at the US LIBOR rate.

[329] The currency and swaps were transacted in accordance with the International Swap Dealers Association (ISDA) master agreement, with the terms and conditions of each swap being confirmed in an exchange of correspondence.

(2) Economic Substance (Investment or Loan)

[330] These transactions were, I am satisfied, loans in economic substance, as recognised by US revenue law. In Koch, TBNZI paid funds to KCS and acquired in exchange an asset constituted by Kiwi's preference shares. If the transaction had ended there, its legal and economic substance would have coincided in a straightforward purchase of property. But all the other instruments and arrangements converted its financial characteristics into those of a loan.

[331] The essential elements of the related arrangements were: (1) TBNZI's agreement to sell the preference shares back to KCS within a limited period which could be accelerated; (2) a prohibition on TBNZI from dealing with or disposing of the shares, whether during the period of its ownership or following KCS's contingent default in repurchasing, and its conferment of a first lien over the shares to secure its sale obligations to KCS; (3) TBNZI's entitlement to an annual return on its asset in the nature of a dividend at a fixed rate payable irrespective of the underlying value of the asset; and (4) KII's guarantee of KCS's obligation to repurchase.

[332] TBNZI's payment to purchase the shares was in essence a debt owed by KCS. The money was advanced subject to an unconditional obligation to repay on or before a date certain. KCS agreed also to pay the economic equivalent of interest quarterly at a fixed rate. KII's guarantee was for the sole purpose of securing

repayment. As Professor Saunders and Mr Marcus Stanton opined for the Commissioner, the cash flows were characteristic of a loan.

[333] Another important feature, pointing towards the transaction's economic substance as a loan, was the right to early termination. It is unnecessary to subject these rights to detailed analysis. I agree with Mr Brown that they allowed Westpac to end whole or part of a transaction almost at will.

[334] Westpac employees considered the transaction to be a loan regardless of its legal status. Some proposal documents and internal emails referred to the transaction as lending. It was similarly treated for the purposes of management accounts. And in unguarded moments, Mr Farmer referred to the transactions generically as lending. All of this is consistent with Westpac's business of banking, the prime function of which is to obtain an economic return on the cost of funds deposited from time to time.

[335] The transactions would never have been economic for either party if they were not treated according to their economic substance as loans in the counterparty jurisdictions. Dividend payments by the counterparty were deductible as interest on loans and the receipts were tax exempt for Westpac. This asymmetry created the opportunity for the bank to deduct its expenses incurred in funding the exempt returns and, arguably, share those along with other tax benefits with the counterparty.

[336] There was, I am satisfied, a significant disjunct between the economic substance of the Koch transaction as a loan and its legal form as an equity investment.

(3) Guarantee Procurement Fee

[337] The existence of the GPF is central to the Commissioner's allegation of tax avoidance. Two broad questions arise at this stage of the inquiry: (1) did the GPF perform a justifiable commercial purpose; and (2) if so, was it fixed at market rates?

[338] The answers require a detailed examination of the evidence, focusing on the steps taken by Westpac and the counterparty, together with an assessment of expert opinion on the fee's true value. The GPF's relationship to other components of the financing of the transaction will demand separate consideration. Before considering these issues, I should briefly provide some financial context to the GPF.

[339] The Commissioner alleges that the bank and the counterparty fixed a dividend rate on the preference shares for the purpose of dividing Westpac's taxation benefits including its right to deduct expenses. There were three principal items of expenditure – interest on borrowing, swap losses, and the GPF. The parties have aggregated the first two items under the cost of funds. Westpac's borrowing costs were easily the larger expense – swap losses were relatively small and were not ascertainable in advance. So, for example, on Koch, the Commissioner estimates Westpac's cost of funds, being interest at LIBOR, for the 2000 tax year at $26.176m (including a netted off swap loss of $3.454m).

[340] The amount of the GPF was somewhat less but still substantial. Westpac's GPF expenditure on Koch for the 2000 tax year was $10.946m. Of the total core tax of $586m in dispute to 31 March 2009 (leaving aside use of money interest of $375m), the cost of funds and GPF deductions account for 70% or $410m and 30% or $176m respectively.

[341] The Commissioner's specific challenge relates to the GPF's legitimacy: but for the GPF, it is unlikely he would have questioned these transactions. However, Mr Brown responds, but for the GPF it is unlikely the transactions would have proceeded. The lawfulness of the bank's other deductions are not under separate challenge. But their existence is relevant within the wider inquiry into whether there was a tax avoidance arrangement.

(a) Credit Evaluation

[342] Westpac's credit evaluation of Koch's funding application is the appropriate starting point for this inquiry. Mr James Coleman was Westpac's principal witness on this topic. He was its general manager of risk management from March 1996.

Later he held the position of group chief credit officer. At all material times he was responsible for the conduct of the bank's wholesale risk evaluation process. Westpac's credit policy for risk grading exposures to subsidiaries of multinationals was set out in a comprehensive manual.

[343] Mr Coleman said that:

(1) The vast majority of multinational subsidiaries with which Westpac does business are actively engaged in sourcing, manufacturing, distribution and/or marketing. The bank typically seeks a parent guarantee of its credit exposure to a subsidiary given the control which the former can exercise over the latter. The subsidiary is allocated the same risk grade as the parent once a guarantee is provided;

(2) Where the parent does not provide a guarantee, Westpac evaluates the borrowing subsidiary's financial condition and operating performance on a stand-alone basis. The bank recognises the prospect of implied parent support if the subsidiary's stand-alone financial position is sound, the nature and structure of its risk exposures are appropriate to its business, and an appropriate level of continuing parent support exists. In this event, Westpac will risk grade its exposures to the subsidiary one grading below that assigned to the parent. Otherwise the bank will assign a risk grading based on the subsidiary's stand-alone financial and operating position without recognising parental support;

(3) Because it extends term exposure, Westpac has a different approach from the rating agencies to implied parent support. The bank places more weight on the soundness of the subsidiary's business than on implied support, knowing that this factor falls well short of a legal obligation to repay.

[344] I interpolate here to make three observations. First, Mr Coleman was discussing the situation where a multinational's subsidiary applies for funding in its own right and for its own purposes, which was not this case. Second, it is implicit in Mr Coleman's evidence, and express in that of other witnesses, that without a guarantee, the bank would expect a greater return on its funding, whether by way of an above market interest rate on a loan or a higher dividend rate payable on a preference share.

[345] Third, the cost of the security of a guarantee is normally reflected in a reduced price of funds payable to the financier. Westpac's standard and preferred course is, I infer, to evaluate whether the subsidiary is creditworthy in its own right before considering whether to require a guarantee. Again that did not happen here.

[346] Westpac, Mr Coleman said, operates internal capital allocation and provisioning systems to estimate the cost of each credit allocation which it then passes on to the originating business unit to reflect its profitability. A charge is imposed for both expected and unexpected loss.

[347] In the case of the 'expected loss' charge, the cost is directly reflected in the bank's reported financial position. Thus the bank's calculation of the cost difference between a guaranteed and an unguaranteed credit transaction can be seen via what costs it would have charged in its accounts. Westpac's provisioning system estimates the 'expected loss' in each risk exposure, which is then summed to give an estimate of the total expected loss in all of the bank's risk portfolios.

[348] Westpac's capital allocation system estimates the 'unexpected loss' in a given transaction and risk portfolio. The calculation estimates the potential loss in excess of the expected loss using the probability of loss implied by Westpac's senior debt rating. The methodology used in this calculation also captures 'concentration risk', i.e. the increased risk of loss when a portfolio contains especially large single exposures. Thus the result of the Westpac capital allocation is that larger exposures are allocated a higher capital factor than smaller exposures of the same risk grade.

[349] According to Mr Coleman, if KII had not guaranteed KCS's obligations but the transaction was still approved, Westpac would have allocated a risk based credit charge for 'expected loss' and a risk based capital charge for 'unexpected loss to the business unit, significantly greater than the fee the business unit agreed to pay to KCS to obtain the parent guarantee'.

[350] Without some form of credit enhancement, Mr Coleman said, KCS was not an acceptable counterparty to the forward sale agreement. The company was a special purpose, non-operating subsidiary which 'up-streamed the proceeds of its capital raising to its parent', was not independently capitalised for its business risks, and had no operating business which generated profits of its own. Thus, it was unable to service its liabilities without financial support from its parent. And at NZD390m, Mr Coleman noted, this was a very large transaction.

[351] Mr Gibbs did not remember the reason for KCS's introduction as the forward sale counterparty in KII's place in February 1998. However, once KII was no longer the direct obligor under the forward sale agreement, the parent's guarantee of that obligation became essential to Westpac 'for credit reasons given the assumed uncreditworthiness of Koch affiliate'. Like Mr Coleman, Mr Gibbs did not explain why Westpac made that immediate and enduring assumption.

[352] Mr Gibbs proceeded on the same basis when preparing the SFC proposal in May 1998. At that time he thought that the Koch affiliate would be as non-creditworthy as the originally proposed AIG subsidiary.

[353] Despite the transaction's size, it is common ground that Westpac failed to evaluate KCS's creditworthiness in accordance with its standard requirements. Mr Coleman's rationalisation for this failure was that:

> **It was always understood that KII would undertake the transaction through a special purpose subsidiary… KCS was named later.** The [b]ank never expected the subsidiary to have any creditworthiness in its own right; it would be an entity entirely dependent on the parent for its ability to meet its obligations to creditors.
>
> This position was obvious at the outset; it would not have required analysis or discussion.
>
> [Emphasis added]

[354] Messrs Coleman and Gibbs' explanations for Westpac's failure to assess KCS's creditworthiness corroborate what is apparent from the contemporaneous documents. The bank was indifferent throughout as to the identity of the legal borrower or funding recipient. That was because, in Mr Coleman's words, confirmed by Mr Gibbs, 'it was always understood that KII would undertake the transaction'.

[355] And Mr Coleman's understanding that KCS 'upstreamed the proceeds of its capital raising to its parent' was telling. Where special purpose subsidiaries are used, as Westpac's experts confirmed, the parent will offer as a matter of course to guarantee performance of the subsidiary's obligations to preference shareholders. And the parties understand the funds raised will be used for the group's purpose, with the guarantee's cost if any reflected in the dividend rate.

[356] Mr Marcus Stanton, a London banker called by the Commissioner, illustrated this point by reference to the Rabo transactions. He said that Rabobank, with an AAA rating, would have been able to borrow at LIBOR plus a small interest margin of 0.15%. In Mr Stanton's experience, where a large company raises debt on the international markets through a special purpose subsidiary backed by a parental guarantee, no separate fee would be payable by the debt providers, either in return for the guarantee or its provision. The whole structure would be regarded as a composite, as it was in these transactions, and the parent's standard cost of borrowing would be the dividend rate.

[357] Mr Moorad Choudhry, another London banker called by the Commissioner, was of the same opinion. To him there was no commercial logic in the financier or lender paying a GPF where the recipient or borrower is a wholly owned subsidiary of the guarantor. The norm in such cases is for the parent to give a guarantee without charge. I accept the evidence of both Messrs Stanton and Choudhry on this point.

[358] Mr Coleman's introduction of the credit enhancement concept became the cornerstone for Westpac's argument that the GPF was set at market levels. But, it must be asked, whose credit was the GPF designed to enhance? It can hardly have been provided to improve the credit of a company which Westpac was not interested

in rating. In truth the bank was not advancing credit to that entity at all. KCS was simply interposed as a matter of convenience without a commercial rationale after the transaction was proposed.

[359] If the position was otherwise, Westpac would certainly have credit rated KCS. Dr David Ellis – a Westpac expert whose evidence I shall discuss shortly – made the point in this passage from his supplementary brief, emphasised by Mr Farmer in closing:

> Once it is established that the guarantees at issue entailed a transfer of credit risk, in order to quantify the reduction in risk due to the guarantee the creditworthiness of both the guaranteed entity and the guarantor must be ascertained. **Since the FSA counterparties were unrated entities, a reliable evaluation of their creditworthiness is therefore an essential requisite to estimate the value of the guarantee in each of the transactions**…
>
> [Emphasis added]

[360] Westpac's failure to follow its settled procedures and credit rate KCS is consistent with one inference. The bank never intended to provide a discrete funding facility to a stand-alone subsidiary. The Koch group was to be the economic beneficiary. It was always envisaged that the parent alone would be responsible for all repayment obligations.

[361] I appreciate that Westpac had to articulate a justification for the GPF at trial. But the bank's engagement of the credit enhancement thesis ran counter to its own evidence that Koch, not KCS, was the designated economic borrower of its funds.

(b) Security

[362] However, in an attempt to provide an evidential basis for its credit enhancement proposition, Westpac engaged two banking witnesses, Mr John Rex and Professor Richard George. Both conducted retrospective evaluations of KCS's creditworthiness in 1998.

[363] I entertain serious reservations about the relevance of such evidence. It is designed to prove through the route of reconstruction what would or might have

happened if Westpac had acted prudently and according to its procedures before entering into the transaction. But it is the bank's failure to rate the credit of the legal borrower or recipient, not the result of the evaluation, which is significant in the context of this inquiry. Furthermore, as I shall explain, this evidence ultimately served to highlight the inconsistencies in the Koch transaction's economic substance and Westpac's approach to its legal structure.

[364] Both Mr Rex and Professor George concluded that the company was a poor credit risk on a stand-alone basis. As at 31 December 1998 KCS's equity was USD58.6m compared to liabilities of USD206.8m. It had contingent liabilities of NZD390m under the forward sale agreement. KCS was not integrated into the Koch group even though it was described as an investment company. Its principal asset was its investment in Kiwi; and Kiwi's sole asset was its loan to KII.

[365] Again on the premise of stand-alone financing, Professor George and Mr Rex were of the opinion that Westpac would have acted irresponsibly and imprudently if it extended credit to KCS without formal support from a highly creditworthy or rated entity. On the ratings conducted by globally recognised agencies, such as Standard & Poors, Moody and Fitch, KII's rating was AA+ (or equivalent), reflecting a company unlikely to default on its obligations. (Westpac, by comparison, had a lower AA- rating.) Both experts concluded that a KII guarantee would have been the best security possibly available for performance of KCS's obligations.

[366] As a statement of general principle, this conclusion cannot be faulted. However, it takes no account of the economic reality of the transaction or for these purposes its underlying value. Westpac purchased from KCS for NZD390m (or USD200m) all the non-voting preference shares in Kiwi. That stock carried a right to fixed dividends at the rate of 7.7177% per annum. Kiwi's loan of USD226m to KII in return for a promissory note for repayment and interest at USD LIBOR rates was its sole (and substantial) asset.

[367] Mr Farmer described the shares as Westpac's 'primary investment', consistently with his emphasis on the transaction's legal structure. However, the bank failed to consider an obvious step to secure its 'primary investment', despite

spending NZD390m. It did not investigate the availability of an assignment of or security over the note as a condition of its funding. By stipulating for this result, the bank would have obtained a right of direct recourse against KII for its full indebtedness if KCS defaulted, irrespective of its rights under a guarantee.

[368] Moreover, despite their status as Westpac's 'primary investment', the bank failed to evaluate the independent worth of the shares it was purchasing or the security they might offer if KCS defaulted on its repayment obligation. This feature emerged during Mr Farmer's cross-examination of Dr Desmond Fitzgerald, a London banker and economist called by the Commissioner. In his opinion, assuming they could be traded, (consistently with an orthodox equity investment), the shares would have had an independently sustainable worth on the open market. Dr Fitzgerald pointed out that the dividend rate was most attractive (well above LIBOR), and was backed by Kiwi's interest bearing loan for USD226m to its parent.

[369] In this respect I accept the evidence of Professor Anthony Saunders, Professor of Finance at the Stern School of Business at New York University. His experience lies in analysing financial market transactions focusing on bank and other financial institution activity. Like Dr Fitzgerald, he was satisfied that Kiwi's promissory note meant neither Kiwi nor KCS were uncreditworthy given that Kiwi's primary asset 'consisted of parent company obligations'. He viewed the financial interests of KII and Kiwi as interlinked.

[370] Professor Saunders' opinion was that, as a matter of economic reality, if KII defaulted under the promissory note, it was also likely to default on a guarantee. While KII may have been able to raise legal defences to a claim by its subsidiary under the note, unrelated to its reasons for defaulting under the guarantee, that prospect would be practically remote given the existence of parental control. More realistically, underlying liquidity or related financial problems would likely lead to the same result of a default under either instrument – whether the guarantee or the promissory note.

[371] Westpac cannot now distance itself from a focus on the value of the preference shares. The bank's unexplained failure to investigate the underlying

worth of the assets to be acquired or at least factor its value into the amount of the GPF undermines its unyielding thesis that Koch was an equity acquisition. It also suggests indifference to a critical feature on a scale that again calls into question the bank's commerciality.

[372] It may be rhetorically asked: what prudent banker, acting commercially, would agree to return to the economic borrower or legal seller a fee equivalent to 37% of its income stream, or about $11m annually, without first exploring whether, by taking advantage of the security available from the assets it was purchasing, alternative means were available to achieve whatever financial benefit was inherent in that fee, either free of a cost or a cost of that magnitude? In my judgment Westpac's failure was the antithesis of a bank's traditional objective of increasing its returns on funds by lowering all possible costs where, as Mr Farmer emphasises, it 'borrow[s] to lend or to invest at a margin'.

[373] Westpac foresaw its vulnerability in this respect. It called pre-emptive evidence from both its security experts. Mr Rex accepted there was scope for Westpac to require an alternative security structure providing direct recourse to KII, but considered that even this result would not have been 'watertight'. He referred to KII's ability to weaken the value of Westpac's investment by modifying the terms of the promissory note in a manner disadvantageous to Kiwi; and to the risks of a reduction of interest payable on the loan, extending its repayment date, subordinating it to other creditors of KII, or a combination (KII could also have refused to provide KCS with funds to meet its forward purchase obligations).

[374] In Mr Rex's opinion, in order to be able to regard the risk rate on the credit exposure to KCS as equivalent to that of Kiwi's assets (that is, its loan to KII), Westpac would have required satisfaction that, first, no other significant creditors had competing claims on Kiwi's assets (which was achievable by a prohibition on the company incurring any additional liabilities or by placing Westpac in the same position as a secured lender); and, second, Kiwi's claim under the promissory note could not be jeopardised, and in particular the loan agreement protected it adequately against any contingent events by including negative and affirmative covenants, a detailed agreement governing Kiwi's loan to KII and provision of security.

[375] Mr Rex accepted that on satisfaction of these conditions the loan note would provide security approximate in nature and effect to KII's guarantee commitments. Professor George was of a similar opinion. He noted that Westpac obtained no claim on Kiwi's assets when purchasing its preferred shares. The credit risk assumed by the bank related to Kiwi's ability to generate sufficient cash to pay the contractual dividends due on the shares, either from operations or by liquidating assets. Kiwi was structured so that its assets would generate just enough cash for this purpose. A prudent banker would normally require evidence that earnings would cover interest and other cash obligations by several times.

[376] Westpac now relies on Mr Rex and Professor George to justify its failure many years earlier to explore an obvious avenue of security in substitution for or addition to KII's guarantee. The potential financial benefits were obvious: either in sparing Westpac the cost of a GPF if it was satisfied that a charge over the promissory note was sufficient security; or in using that factor as a means of negotiating a reduction in the GPF's amount.

[377] It is not now necessary or possible to determine whether in fact the bank would have obtained an assignment or charge if sought as a condition of the financing. Nor is it necessary to demonstrate that a charge over the note would have been more or less financially attractive than a guarantee. What is material, however, is Mr Rex's acceptance that Westpac could have achieved that result; and that its security position would have been enhanced accordingly, possibly to the equivalent status and effect of a parent guarantee. And in that event, of course, payment of a GPF would have been unnecessary or much reduced in amount.

(c) Fee Concept

[378] However, I shall proceed on the premise that it was prudent to require a parent guarantee if Westpac did not obtain a satisfactory alternative security for its investment in Kiwi or KCS. Here, the dividend rate payable by Kiwi might possibly have been set lower to reflect the protection of Westpac's credit risk provided by KII's guarantee.

[379] Mr Farmer submits that instead 'the parties chose to separate out the value of the parent guarantee and have that amount paid as an explicit fee (the GPF) by Westpac'; that the economic effect was the same from the counterparty's perspective in terms of the net cost of funding it was required to pay Westpac; and that:

> … the payment of an explicit fee for the parent guarantee was a legitimate commercial alternative to incorporating the value of the guarantee into the distribution rate, and entirely rational commercial behaviour given that the GPF was deductible to Westpac.

[380] Mr Rex and Professor George supported Mr Farmer's concept of 'unbundling' risk elements in a transaction. As Mr Rex said:

> I see no reason in principle why a lender or investor should not pay a fee for provision of a parent company guarantee and charge the borrower or investee company a higher rate which reflects the return which would be required in the absence of a guarantee. Much of the activity in the international financing arena involves "unbundling" risk elements in transactions so that each of them can be placed with counterparties who are willing to accept them at the most attractive commercial pricing.
>
> [Citations omitted]

[381] Professor George was to the same effect:

> … [T]he payment of the [GPF] by Westpac was a legitimate commercial alternative to the practice of incorporating the value of a guarantee into the return on a guaranteed security (the dividends on the Kiwi preferred shares in the case of the Koch transaction). Another way to structure the Koch transaction could have been for the parent's guarantee to be provided without direct cost to Westpac. The dividends would then have been reduced. However, this approach would not reveal pertinent details of pricing the return on the shares and the true cost of the guarantee. It would also prevent a true comparison of prices against market benchmarks and may be less attractive from the standpoint of ensuring accurate accounting… From a credit point-of-view, I consider the transaction's structure reasonable and in keeping with standard banking practices.

[382] Mr Farmer's argument strikes an immediate legal obstacle. It proceeds on the premise, previously rejected at the deductibility stage, that the GPF was paid in consideration for provision of a guarantee. Consistently with Mr Green's economic substance argument on that issue, Mr Farmer submits that 'it is clear that all but a small proportion of the fee was in consideration for the guarantee', with the term 'procurement' conveying the concept of a fee being payable to a person other than the guarantor. This is not to say, Mr Farmer submits, that the procurement aspect of

the GPF was illusory. Indeed in each case the counterparty satisfied its legal obligation by procuring that guarantee.

[383] Westpac's payment of a GPF of 2.85% of the transfer price was, I repeat, in express consideration for KCS's act of procuring the guarantee, not in exchange for KII's guarantee itself. While economic substance is a relevant factor in the avoidance inquiry, I am not satisfied that the bank can resort to it to justify the fee's existence on a different ground by contradicting its deliberately chosen legal structure. The opinions expressed by Mr Rex and Professor George proceeded on this basis. I shall address them briefly, subject to that qualification.

[384] Unbundling may, I accept, be appropriate, but in a very different financial market as Dr Fitzgerald explained. In his experience of 'simple structured transaction[s]', such as this, a guarantee fee, if payable, will 'universally … be paid by a reduction in the rate of return'. The guarantee component might, however, be severed where a transaction is complex. Examples are where there are 'commodity … and equity links and all sorts of other things'.

[385] In their collective experience, Mr Rex and Professor George have never encountered this type of 'unbundling' – that is, where the financier or owner of preference shares pays a direct fee, whether called a GPF or a guarantee fee, back to the guarantor or subsidiary.

[386] Moreover, I do not accept that Westpac ever made a conscious decision in fact to unbundle the financing components of this transaction in the manner hypothesised by Professor George. This rationale did not appear in any of the contemporaneous documents. It did not emerge until early 2000 when, to use the words of one Westpac employee, the bank was required to 'put some science around' the GPF in answer to the Commissioner's inquiries relating to First Data.

[387] I shall return to this 'unbundling' subject more fully when considering Westpac's argument about the composition of the dividend rate. At this point I record my satisfaction that a discrete fee, whether paid to procure a guarantee or for

the guarantee itself, was never commercially justifiable for Koch or the other transactions.

(d) GPF Amount

[388] Assuming for these purposes, however, that the GPF was justified, the question arises: how was the fee quantified?

[389] The GPF concept was first raised when the AIG proposal was floated. Mr Gibbs noted in an email on 5 May 1997 that the fee 'discussed to date has been 2.95% per annum'. He did not recall any discussion or negotiation about its quantum; it was simply 'logical' that this amount reflected the difference in creditworthiness between AIG and its subsidiary.

[390] As Mr Gibbs said:

> While I did not carry out any analytical research on the matter and I do not recall any negotiations of the fee, my primary point of reference for assessing an appropriate level for this fee was the 2.95% that had been agreed for the AIG transaction, which I regarded as a benchmark… Based on this benchmark, and having regard to the marginally lower credit rating of KII (AA+) compared to AIG (AAA), the similar non-creditworthiness of the repurchase entities, the knowledge that an appropriate credit margin for a party was often expressed as a range rather than a single figure and taking into account that margins could vary over time and between like-rated parties, I was satisfied that 2.85% was reasonable for the Koch transaction.

[391] Mr Gibbs' brief evidence is the apparent basis of Mr Farmer's submission that Westpac considered the actual GPF fell 'within a reasonable market range …', based upon a banker's intuition and experience and market knowledge of the GPF at 2.95% in the BNZ/AIG transaction. In itself, however, his submission carries a concession of Westpac's failure to objectively analyse the commerciality of paying KCS $11m a year (a total of $556m on the nine transactions).

[392] And 'intuition' appears at odds with Westpac's carefully regulated decision-making processes and procedures. Mr Gibbs admitted that he had no previous experience with a GPF or a discrete guarantee fee. He made no inquiry to validate his 'logical' conclusion based on the BNZ/AIG transaction. His knowledge that

those two parties had struck the same rate in a similarly structured deal was of no assistance. Westpac was not itself privy to the circumstances or to any credit assessment undertaken by the BNZ.

[393] Mr Gibbs accepted that the original 'indicative pricing schedules' sent by Babcock on 10 March 1998 provided for Westpac to pay KII a guarantee fee of 2.5%. He was unable to recall the reason for the increase on 4 May 1998 to 2.85% in what became the GPF payable to KCS. All he was able to say was that by 29 April, Westpac, Babcock and Koch had 'evidently' agreed the fee of 2.85%.

[394] Mr Gibbs described the structured finance transactions as 'highly tailored in nature', meaning that a transaction was customised to each counterparty. I reject his characterisation. Westpac simply treated the AIG figure of 2.95% as the benchmark throughout. The bank never attempted to calculate the GPF according to the credit standing of either the legal counterparty or its parent.

[395] Experts, whose evidence I shortly discuss, were called on the issue of whether the GPF was fixed within a reasonable commercial range or at a market rate. All proceeded on the common assumption that the pricing component of a parental guarantee, whether included within the dividend rate or as a separate charge, would be the subject of arm's length bargaining. On this hypothesis, the parties' starting points should have been diametrically opposed, with the negotiation process leading to a mutually acceptable compromise. Self-evidently also, the higher the financial stakes, the more intense would be the bargaining process.

[396] However, there was no evidence of any bargaining processes or commercial tension relating to the GPF – a critical component of the pricing structure. Both sides were content instead to accept a standard figure without question or negotiation, even though the GPF amounts at issue were substantial (for example, Westpac would be paying away to KCS a GPF of about 37% of its dividend return).

[397] The bank was, I am satisfied, indifferent to whether the GPF was a true, fair or commercial reflection of the value of the service to be performed; that is, either in legal terms for procuring the parent's guarantee or in economic substance for its

provision; Westpac's failure to evaluate the true worth of the GPF, if a justifiable expense, is, I think, another telling sign of uncommerciality.

[398] The Rabo transactions and others illustrate the consistent pattern of Westpac's uncommerciality in fixing the GPFs. Professor Saunders referred to the 'fundamental principle of finance' that the higher the credit risk, the greater should be the insurance or enhancement fee. He was referring to Westpac's credit enhancement thesis.

[399] But, as Mr Brown points out, there was if anything an inverse relationship between the GPF's quantum and the recipient's rating. For example, GE and First Data were rated AAA and A- respectively; but Westpac paid to the counterparty subsidiaries of both the same GPF of 2.85%. Rabo and Koch were rated AAA and AA+ respectively; Westpac paid a GPF on Koch of 2.85% but paid a GPF on Rabo 2 of 3.212%.

[400] Mr Gibbs conceded to Mr Brown that the GPF on Rabo 1 was adjusted from 2.95% down to 2.92% to reflect changes in the swap rate. He made no reference to an individual credit adjustment. However, on Rabo 2 the GPF was adjusted upwards from 2.95% to 3.2512% because, Mr Gibbs admitted, the swap rate had moved in the other direction. Earlier in direct contradiction, he had asserted that the GPF could be fixed in isolation from and in advance of setting the dividend fee because the two were independent – the fee being related solely to the credit differential between the two parties.

[401] Mr Farmer rationalises this damaging conflict by saying that the purpose of the Rabo 2 adjustment was 'to keep the sum of the GPF and the swap rate constant'. I am unable to accept his explanation; if anything, it confirms that the fee was adjusted for reasons other than Rabobank's creditworthiness, a point acknowledged by Mr Gibbs to Mr Brown when discussing an alteration in the Koch GPF.

[402] Nor am I able to accept Mr Farmer's submission that 'this [change] resulted in minor adjustments' to the initially agreed GPF of 2.95% on Rabo 2. Westpac paid NZD800m on that transaction. A differential of 0.3% between 2.95% and 3.25%

equated to NZD2.4m annually or NZD12m over the projected five year term. The bank's unquestioning agreement to substantial increases in the GPF, when according to Professor Saunders' 'fundamental principle' the fee should have been reducing, is inexplicable unless it was for a purpose unrelated to the transaction's underlying commerciality.

[403] I add that, as part of the First Data inquiry in early 2000, the Commissioner asked why the GPF was being paid to the subsidiary and not the parent. On Westpac's instructions, Simpson Grierson replied that its purpose was to enable the GPF to be set off against the forward transfer obligations assumed by the counterparty. The Commissioner subsequently inquired about whether this was the rationale for the GPF, Simpson Grierson responded that its additional purpose was to satisfy the foreign exchange requirements of the First Data counterparty. Mr Gibbs accepted that neither of these reasons played 'any substantive part' in his thinking when setting the GPFs.

(e) GPF: Commercial Value

[404] Westpac says that, even if the GPF was struck without reference to any tangible or objective measure, the credit differential between KCS and KII was such that the fee actually agreed of 2.85% was nevertheless within a reasonable range of commercial market values for obtaining its benefit. The bank relied on expert evidence to produce a notional open market value of that credit differential when the GPF was fixed.

[405] Westpac called Mr Anthony Seve and Dr Ellis: the former is the Sydney based national lead partner of KPMG's global transfer pricing service practice; the latter is an associate director of NERA Economic Consulting based in London. As Mr Farmer observes, the pair produced different 'but broadly consistent results', reflecting that 'there is more than one way to go about the valuation task'. The Commissioner called Dr Fitzgerald and Professor Saunders in answer.

[406] The BNZ ran a similar argument against the Commissioner. Following his finding that the GPF fixed in that case was in fact a contrivance, Wild J undertook a

discrete inquiry into whether the fee's pricing was 'within market parameters'. The Judge rejected evidence from the bank's experts (not Mr Seve and Dr Ellis): see *BNZ Investments (No 2)* at [331]-[359]. He preferred Dr Fitzgerald's conclusion that, even assuming a genuine and commercial justification for BNZ to pay a parent guarantee, its internal cost, as opposed to an open credit enhancement market cost, was in the range of 0.45-0.65%. Mr Farmer observes that the BNZ did not call 'the same extensive evidence [as Westpac] as to the value of the GPF'.

[407] The inherent artificiality of reconstructing what was not done some years previously in an attempt to value a guarantee component separate from the whole funding package forced Mr Seve and Dr Ellis to undertake complex mathematical modelling. It is no reflection on the skill or competence of either witness to observe that their methodologies increasingly lost touch with the reality of these circumstances. Mr Farmer's description of their evidence as 'reasonably complicated' was an understatement.

[408] In summary, Mr Seve engaged the Probability of Default Factor (PDF) method, an actuarial calculation of Expected Loss (EL) and Unexpected Loss (UL). As Mr Coleman explained, major banks use this methodology to measure and manage credit risk – to make appropriate provisions and fix adequate levels of economic capital. By applying the PDF method Mr Seve valued the Risk Reduction Benefit (RRB) secured by Westpac through the parent guarantee, equalling the extent to which the guarantee lessened the bank's exposure to credit default.

[409] Mr Seve valued the GPFs for each transaction within the following ranges:

(1) Koch 1.98% - 3.91% (actual 2.85%)

(2) CSFB 1.70% - 3.22% (actual 2.80%)

(3) Rabo 1 2.29% - 3.83% (actual 2.92%)

(4) Rabo 2 2.20% - 3.66% (actual 3.25%)

[410] Dr Ellis applied three alternative methods including Mr Seve's PDF method. The first was the market based or yield spread method. It estimates the value of the

guarantee as the difference in market prices between comparable market securities traded with and without a guarantee. Its premise is that the guarantee's value can be estimated as the change in credit risk faced by the investor due to the agreed transfer of risk from the obligor to the guarantor, leading to a change in the valuation of the investment. The difference in value of the investment without a guarantee, minus the value with a guarantee, represents its fair value – that value is equal to the cost saving which it awards the obligor and associated entities.

[411] Dr Ellis regards this market based or yield spread method as the most reliable of the three, because it is forward looking and based on the market expectations of current and future interest rates and spread loads. By comparison, the other two methods, the PDF adopted by Mr Seve and the Credit Default Swap (CDS), largely incorporate historical statistical data.

[412] Pricing the guarantee as if it were a CDS requires a degree of contingent claims analysis, based on the underlying dynamics of the asset and its underlying liabilities; the guarantee is construed as a put option and the price paid is the option premium. The CDS method is usually applied to a variety of insurance and similar products and is essentially a form of default protection, providing the buyer with insurance against the risk of a specified credit event. And as Dr Fitzgerald pointed out, CDSs did not come into vogue until about 2002.

[413] Dr Ellis considered the fair value of a guarantee to be its worth to each of the parties, determined by the stream of future cash flows and the risks associated with them. He then said:

> One way in which the value of the guarantee can be estimated is therefore as the change in credit risk experienced by either the investor or the guarantor as a result of entering into the guarantee agreement. The change in the risk faced by each counterparty under the guarantee can be calculated as the change in the cash flows that would ensue from the transfer of risk that arises as a result of the transfer of the obligation for payments under the guarantee from the obligor to the guarantor. The effect of the guarantee is to produce a security whose cash flows are the same as if the security had been issued by the guarantor rather than the actual borrower.

[414] Dr Ellis used two different benchmarks to calculate the guarantee's fair value. One was the Westpac Internal Risk Grade (WIRG), the bank's internal risk

assessment tool. The other was shadow rating, following industry standards and practices as close as possible.

[415] Dr Ellis' range of conclusions reached by applying all three methods is shown in the following table:

	Koch		**CSFB**		**Rabo 1**		**Rabo 2**	
Guarantee Procurement Fee Paid (bps)	**285**		**280**		**292**		**325.12**	
Estimated Fair Price Ranges for the GPF (bps)								
Using WIRG								
1. Yield Spread Method	120	280	137	253	137	330	162	364
2. Credit Default Swap Method	196	312	226	335	291	412	258	373
3. Actuarial Method	317	454	470	613	458	601	400	534
WIRG Range	**120**	**454**	**137**	**613**	**137**	**601**	**162**	**534**
Using shadow ratings								
1. Yield Spread Method	147	365	72	173	162	360	174	379
2. Credit Default Swap Method	268	396	86	179	366	496	323	445
3. Actuarial Method	390	543	209	316	535	688	467	610
Shadow Rating Range	**147**	**543**	**72**	**316**	**162**	**688**	**174**	**610**

[416] These results confirm the range of values attributable to a GPF when undertaking a reconstructive open market, credit enhancement valuation exercise. The range for Koch is between 1.2% and 5.43%; for CSFB between 0.72% and 6.13%; for Rabo 1 between 1.37% and 6.88%; and for Rabo 2 between 1.62% and 6.10%. It is notable, though, that by applying Dr Ellis' preferred market based method, the starting or low point for each is normally 50% or less (especially applying WIRG) than the GPF actually agreed.

[417] A value can, I accept, be hypothetically attributed to the GPF by using a credit enhancement margin as a proxy for a guarantee fee. But I cannot accept Dr Ellis and Mr Seve's assessments as identifying a then current market price for the agreed GPFs for a number of reasons.

[418] First, the GPF was in fact fixed in all transactions at an early stage, without negotiation and in isolation from any other components of the pricing structure and before the dividend rate was agreed. The figure was frequently above or close to the maximum of the market or yield spread calculation which, on Dr Ellis' table, the

bank's use of its own WIRG would produce. The GPF's existence was an immutable factor dictating the price of the funding.

[419] However, as Dr Ellis volunteered, the GPF's value cannot be fixed as a standalone component, segregated from the value of the dividend rate as a whole. He candidly saw his valuation exercise as being conducted in a vacuum, and being 'a little hypothetical and artificial'. He warned against the distraction of isolating one component within the 'financial engineering' process, 'forgetting that this is a large transaction made up of multiple moving parts'. Nevertheless, that was the very exercise he was engaged to carry out.

[420] In essence, the valuation process started from the wrong place. Westpac did not attempt to assess whether the total pricing of the funds and its component parts were commercially justifiable in the context of the transaction as a whole, as Dr Ellis himself suggested. That exercise was left to Dr Fitzgerald, whose conclusions I shall discuss shortly.

[421] Second, the failure of Westpac's experts to do what Dr Ellis said they should have done and assess the commercial justifiability of the funding as a whole led to gross distortions in the GPF valuation exercise. For example, the outer bounds of one of their three valuation methods produced a discrete GPF on Rabo 1 of between 5.35% and 6.88% (as opposed to the actual of 2.92%). These figures were within 58%-74% of the dividend rate actually agreed of 9.2%. On that premise the transaction would have been an impossibly uneconomic proposition for Westpac, illustrating why the GPF must always be a function of the overall rate, not its determinant, and why a strictly arithmetical valuation approach is unreliable.

[422] Third, Dr Ellis proceeded on the not unreasonable assumption that 'financial guarantees are the result of arm's length negotiations between buyers and sellers of such instruments'. He observed:

> Financial guarantees are the result of arm's length negotiations between buyers and sellers of such instruments. Both parties will have a limit, known in economics as a "bound," [sic] on the price that they will be willing to pay or receive, and the agreed price will lie somewhere within that range. The investor will not be willing to pay more for the guarantee than the equivalent value of the reduction in risk that he or she experiences

> from entering into the guarantee; this is therefore an *upper* bound, or ceiling, in the value of the guarantee. Similarly, the guarantor will not be willing to receive less in guarantee payments for providing the guarantee than the increase in risk he or she experiences from providing the guarantee; this is therefore a *lower* bound or floor.

[423] The absence of that feature, and of any market against which other or similar values could be compared, drove Dr Ellis to apply a very different criterion (he did not attempt to use the other structured finance transactions as precedents). His starting point was the cost to the subsidiary or obligor of purchasing guarantee cover on an open market. In accordance with Westpac's credit enhancement thesis, Dr Ellis adhered to a strict juristic analysis of the instruments and their terms – particularly the forward transfer and GPF agreements and the deed of guarantee.

[424] Consequently, as emerged during Mr Brown's cross-examination, Dr Ellis' valuation deliberately excluded, to its detriment, three critical factors: (1) the nature and extent of the advantage available to the parent from the ultimate receipt of Westpac's funds; (2) that factor's influence on the price the parent might seek and a prudent banker might be prepared to pay for a guarantee; and (3) the economic reality that the parties never intended that Westpac would provide funds to KCS as a standalone entity but the Koch group was to be responsible for the debt.

[425] Another passage from Dr Ellis' evidence, cited by Mr Farmer in closing, discloses the extent of his focus on the juristic structure instead of the primary evidence and economic reality. Dr Ellis said this:

> Since the primary purpose of a financial guarantee is to enable a low rated company to borrow at a better rate (or in an extreme case to borrow at all), this is precisely the situation where the value of a guarantee becomes apparent: **the guarantee will enable a transaction to take place that otherwise could not have proceeded**.
>
> [Emphasis added]

[426] This transaction was not designed to enable a low rated entity to borrow at a better rate. It was designed to enable the Koch group as a whole to borrow. As Mr Coleman said, KCS was nominated after the transaction was proposed. The low rated entity was simply a vehicle of convenience, introduced to structure a loan as an equity acquisition of assets.

[427] I prefer the evidence of Messrs Stanton and Choudhry of market practice where a large company raises debt through a special purpose subsidiary; in that event, no separate fee is payable by the debt providers for the parent's provision of a guarantee (see [357] above). Westpac would have had a strong case for minimising if not eliminating payment of a guarantee fee given that the Koch group was the collective beneficiary of the bank's funding. That factor coupled with the inter-company counterparty structure negates any analogy with the cost of credit enhancement notionally available from an unrelated third party on the open market.

[428] In my judgment Dr Ellis' hypothetical, fair value approach is inappropriate where there was no market for a fee similar in concept to the GPF or never a prospect of Westpac paying a fee to an unrelated third party to enhance KCS's credit.

[429] Fourth, neither of Westpac's experts had experience of valuing a GPF or a similar fee in this context. Mr Seve, however, is often engaged to price a parent's guarantee of a subsidiary's obligations for the purpose of fixing fair value in group accounts. In that situation he has valued the notional guarantee fee within a range of up to 1%. But, I repeat, provision of a parental guarantee bears little relationship to fixing fair or market value by reference to the cost of buying credit enhancement from an unrelated party.

[430] A valuation is, as Dr Ellis observed, an art, not a science; it is the product of judgment based upon all relevant facts. Expert evidence in the absence of a market is of very limited assistance. I must apply my judgment based on whatever evidence is available.

[431] Based upon the only possibly comparative evidence produced by Westpac's valuers, I am satisfied that Mr Seve's 1% sets the outer limit of what these participants might have used as a starting point for negotiations on the GPF, assuming of course any credit enhancement fee was justifiable. The figure fixed following genuine arm's length negotiations would likely have been much less, at the very maximum 0.50% of the funds. In my judgment the GPFs actually paid were not within hypothetically justifiable commercial or market parameters.

[432] Dr Fitzgerald corroborated this conclusion. He combines a blend of skills as an economist and banker with particular experience of volatility and arbitrage trading in the major fixed income, equity and commodity markets. He presented as a robust witness whose practical commercial sense was enhanced by a deep knowledge of the markets and their daily operation. His answers in cross-examination by Mr Farmer were balanced and informative. I have no hesitation in accepting his evidence.

[433] Dr Fitzgerald served between 1988 and 1993 as director and head of arbitrage at Mitsubishi Finance International Plc, the securities arm of Mitsubishi Bank. The bank itself was then rated AAA; the subsidiary by which he was employed was unrated. He had never heard of the concept of a fee paid to one entity within a group structure to procure the parent's guarantee. Its existence here, he said, is 'an artificial construct which does not reflect normal commercial practice'.

[434] In Dr Fitzgerald's experience the process of obtaining a parent's guarantee for the subsidiary's activities, if one was required, was straightforward. A price of around 0.10-0.20% (10 or 20 basis points) was usually sought, and reflected in a lower return for the end investor or absorbed in part or entirety by the subsidiary if that still created a satisfactory return. Dr Fitzgerald would place primary weight on the cashflows in Kiwi if called upon to value a guarantee fee in Koch. (Dr Ellis also explicitly recognised the value of the assets purchased by Westpac.)

[435] Dr Fitzgerald regarded Kiwi's loan to its AA+ rated parent as particularly significant; from his objective market viewpoint, reinforced by the commonality of Koch group interests and management, the dividend rate payable on the Kiwi preference shares reflected the credit quality of the KII promissory note at AA+. He was not particularly influenced by the stand alone rating of KCS as, for example, BB-. Instead Dr Fitzgerald took account of Westpac's contractual rights under the forward transfer agreement.

[436] Dr Fitzgerald independently allowed for the prospect that experienced bankers, applying a credit differential, would negotiate on two hypotheses: (1) the internal cost of a guarantee to the guarantor was a maximum of 30 or 40 bases points

(0.30%-0.40%); and (2) the credit enhancement available on the market would be up to 75-100 basis points (0.75%-1.00%). A compromise would then be struck within those parameters as part of the give and take of commercial tension. In Dr Fitzgerald's view, the orthodox credit differential approach was inappropriate in this circumstance, particularly given the overwhelming likelihood of parental support in the event of KCS's default.

[437] Dr Fitzgerald accepted the calculations made by Dr Ellis and Mr Seve as an accurate representation of the level of a credit enhancement fee consistent with raising a B or BB- credit rated subsidiary to that of a parent's AA- or AAA. But he did not accept the reliability of that approach in the very different context where funding was provided to the group. In Dr Fitzgerald's opinion, a competent credit analyst, examining the structured transactions as a whole, would not rate the subsidiaries as low as BB-. All the other factors, summarised above, particularly the fact that this was group funding, would lead to a very different result from that achieved by applying a theoretical credit enhancement approach.

[438] Professor Saunders was to the same effect. In his opinion the GPF was unjustifiable for a number of reasons: it failed to respond to economic considerations; it ignored the implicit likelihood of informal parental support; the levels of the fee were too large given comparable default rates over the relevant time periods; and the levels did not reflect default risk exposure, the actual capital allocated in procuring an explicit guarantee, or additional credit support already available. It is unnecessary for me to recite the factual foundation for these conclusions as they were not the subject of challenge. I accept Professor Saunders' opinion.

[439] In summary, I am not satisfied that Westpac has identified a reliable open market value for the GPFs in the relevant years between 1999 and 2002. The bank's credit enhancement approach could not provide an accurate or realistic measure of fair value. But, if that was possible, I repeat that the GPFs actually agreed did not satisfy any objective or fair measure of value and were not within an acceptable market range.

(4) Dividend Rate

[440] Another central feature of the tax avoidance inquiry is related to the GPF. It concerns the nature of and extent to which the parties shared the tax benefits available to Westpac through the pricing formula used to derive the dividend rate on the preference shares.

[441] Two competing propositions emerged. Was the dividend rate limited to sharing the counterparty's interest deductibility and Westpac's income exemption – the first or cross-border taxation asymmetry? Or did the rate serve a wider purpose, as a mechanism for delivering in addition an agreed share of the bank's entitlement to deduct expenses – the second or domestic asymmetry? Westpac asserts the former; the Commissioner contends the latter.

[442] In *BNZ Investments (No 2)* the taxpayer conceded that the dividend rate was fixed to include both asymmetries. Mr Farmer characterises the BNZ's conduct as 'misusing the [dividend] formula in order to increase deductions'. By comparison, he says, Westpac's approach was commercially pure. He adds that at trial in *BNZ Investments (No 2)* the bank failed to provide detailed evidence or an analysis of how the formula worked.

[443] Mr Farmer's careful argument is founded upon the express premise that the GPF was fixed at or near market rates. He acknowledges that his argument cannot succeed if the fee was not within a commercially justifiable range. I have found against Westpac on that issue. Strictly speaking, it is unnecessary for me to consider Mr Farmer's submission further, However, the extensive discussion which follows is against the contingency that my primary findings on the GPF are in error. The assessment will also be germane to the wider tax avoidance inquiry.

[444] Mr Farmer argues that the GPF was not a fixed component of the dividend rate calculation, despite the weight of contemporaneous evidence to the contrary. He says, however, that the formula did include an element which by coincidence was exactly equal to the amount of the GPF. But this was in fact a credit enhancement

margin, he says, and the GPF sat independently to the side as an offsetting mechanism.

[445] Mr Farmer says Westpac's argument is best expressed in this dividend formula, which assists in understanding how the tax benefit on Koch was split between the parties:

Dividend = [6.955% + 2.85% - 0.14% - 2.335%] x [1-(0.33 x 0.55)]

[446] Mr Farmer submits that the domestic asymmetry – represented by Westpac's ability to claim deductions against other taxable income – was not reflected in the formula and was not shared at all. What was shared, he submits, was limited to the economic benefit of the dividends' exempt receipt for the bank and deductibility of the counterparty's expenditure.

[447] By way of explanation of the two principal elements of the formula, Mr Farmer says:

(1) The swap rate figure of 6.955% was used as an appropriate market opportunity or benchmark rate for both parties for the intended term of the transaction (the NZD five year swap rate chosen was the same as both the transfer price agreed internally between treasury and structured finance and the fixed leg of the swaps used in the transactions). But none of these applications reflected Westpac's actual cost of funds (a contested issue, which will be discussed later);

(2) The 'GPF' figure of 2.85% also represented a market opportunity cost, because it was a credit margin appropriate to measure the issuer's credit status compared to the credit status of the NZD five year swap rate (approximately AA). By coincidence, the credit margin figure used in the formula was exactly the same as the GPF separately paid by Westpac to obtain the credit enhancement of the parent guarantee, representing the credit differential between KCS and KII. If the value of the parent guarantee had been priced within the formula, then its credit margin component would have been zero

(because the parent's credit rating was equal to or above that represented by the NZD five year swap rate) and the dividend or distribution rate would have been reduced accordingly – that is, if the guarantee's value was to be implicitly paid for through a lower dividend or distribution rate, the credit margin would have been zero;

(3) The total of the opportunity or benchmark rate (the swap rate) and the credit margin (GPF) represented (a) the pre-tax rate of return which the investor could otherwise expect from an investment of similar risk to that offered by the issuer (without a parent guarantee) and (b) the pre-tax rate at which the issuer could otherwise expect to obtain funding (without a parent guarantee);

(4) The sharing of the tax benefit – i.e. the dividend's exemption to Westpac and deductibility to the counterparty – was achieved mathematically by multiplying the total of the opportunity or benchmark figure (swap rate) and the credit margin (GPF) by a figure, representing the agreed sharing of the tax benefit;

(5) The parties' negotiations to determine the distribution or dividend rate centred on the multiplier, rather than the opportunity or benchmark rate (swap rate) or the credit margin (GPF), both of which were required to be at market.

[448] Mr Farmer's thesis draws heavily on the evidence of Professor Steven Schaefer, Professor of Finance at London Business School. His particular areas of interest are fixed income markets, risk management, credit risk and financial regulation. Professor Schaefer characterised the preference share instruments as 'hybrids', due to their possession of the characteristics of both debt and equity – that is, the risk characteristics and seniority of such stock in the issuing firm's structure lay somewhere between that of conventional debt and common equity. Many hybrid instruments are designed to retain as far as possible both the flexibility of equity and the tax deductibility of debt interest payments.

[449] Professor Schaefer produced a table of the main terms of 11 public issues by Australian and New Zealand financial institutions of securities which are either preference shares or substantially similar. The first five are set out below:

Exhibit 5

Examples of Australian / NZ Public Issues of Preferred Stock with Dividend Formulae

	Issuer	*Instrument*	*Rating*	*Year of Issue*	*Dividend Formula*	*Life / Redeemable*	*Comments*
1	Fairfax New Zealand Finance (Australian Resident Company)	Redeemable Preference Shares	BBB (S&P)	2005	(1-year swap rate + 1% margin) x (1 - T)	5 years fixed	Dividends grossed up to extent not fully imputed.
2	CBA Capital Australia Ltd	Redeemable Preference Shares	A+ (S&P)	2005	(1-year swap rate + 0.75% margin) x (1 - T)	10 years fixed	Dividends grossed up to extent not fully imputed.
3	Commonwealth Bank of Australia	PERLS (Preferred Exchangeable Resettable Listed Shares)	A- (S&P) A1 (Moody's)	2001	(90-day bank bill rate + 1.85% margin) x Dividend Factor	5 years effective life (callable and puttable – equivalent – after 5 years)	The Dividend Factor (0.7568 for first five years) is based on the corporate tax rate and an estimate of the value of franking credits to investors, assuming the dividends are fully franked. Exchange rights if not fully franked. At bill rate of 5.0%, dividend rate = 5.18408% (7.40583% pretax
4	Commonwealth Bank of Australia	PERLS (Perpetual Exchangeable Resettable Listed Shares)	A- (S&P) A2 (Moody's)	2004	(90-day bank bill rate + 0.95% margin) x (1 - T)	5 years effective life (callable and puttable – equivalent – after 5 years)	Dividends are expected to be fully franked. Exchange rights if not fully franked. At bill rate of 5.0%, dividend rate = 4.165% (5.950% pretax equivalent)
5	Insurance Australia Group	Reset Preference Shares (RPS1)	A- (S&P)	2002	(5-year swap rate + 1.90% margin) x (1 - T)	5 years effective life (callable and puttable – equivalent – after 5 years)	Dividends are expected to be fully franked, grossed up if not. At swap rate of 5.00%, dividend rate = 4.83% (6.90% pretax equivalent)

[450] The multiplier in the various formulae ((1-T)) provided for the issuer and subscriber to share the tax credits available on the preference shares. Professor Schaefer described the 'margin' as 'an opportunity risk premium comparable to the guarantee procurement fee'. That margin ranged between 0.75% for CBA Capital Australia Ltd, rated A+, and 1.90% for Insurance Australia Group, rated at A- (both are well below Koch's AA rating).

[451] In Professor Schaefer's opinion, the Koch transaction had benefits for both sides. For Westpac it was the difference between its after-tax opportunity rate and the 'higher' after tax return on the Kiwi preferred shares. For Koch, it was the difference between its after-tax opportunity rate and the 'lower' net cost of the shares. The Professor said:

> Suppose, for example, that the investor in the shares is an individual investor with a portfolio that is owned outright and not funded from borrowings. For simplicity, I also assume that this individual has the same tax rate as Westpac and therefore, as an investor, faces the same opportunity rate as Westpac.
>
> The calculation that this investor would carry out would be identical to the calculation performed by Westpac and, if the investor and Kiwi were to agree to set the Kiwi dividend to share the transaction benefits equally, the level of dividend that would result would also be the same as that agreed in the Koch transaction. Clearly, therefore, since the investor's position is not funded from borrowings, the formula for the dividend does not depend on the tax deductibility of an assumed interest cost.

[452] Mr Farmer says that the domestic asymmetry was important to the economics of the transactions from Westpac's perspective, just as deductions of dividend payments to Koch were important to its perspective; and that the formula used was 'fundamentally identical' to that adopted in the redeemable preference share transactions, which were approved in *BNZ Investments (No 1)* ('apart from the inclusion of a credit margin equal to the GPF') and which took advantage of the tax free nature of the dividends and interest deductibility then available under New Zealand law.

[453] However, in *BNZ Investments (No 1)*, Mr Farmer says, the redeemable share transactions 'implicitly priced the value of any put option or guarantee … in the dividend'. As a result, the credit margin was zero. Mr Farmer relies on Mr Gibbs'

evidence to the effect that in domestic redeemable preference share transactions a credit margin reflecting the risk of the parent guarantor or option giver was included in the formula if the parent's credit rating was lower than that implicit in the market rate.

[454] Mr Farmer distinguishes between two situations. In one the value of the parent guarantee is implicit in the formula used to price the dividend rate on preference shares issued in a subsidiary and does not have a credit margin component (assuming the parent's credit status is at least equal to the appropriate opportunity rate). In the other, where the value of the parent guarantee is not implicit, the pricing of the subsidiary's shares is based on its standalone credit status, and an appropriate credit margin is required in the formula to determine the appropriate opportunity rate.

[455] On Mr Farmer's argument, the parent guarantee in the second situation is paid for explicitly and separately and the investor's net rate of return is reduced accordingly; that is, the fee paid for the parent guarantee offsets but does not reduce the dividend. The guarantee fee and the credit margin represent the same credit differential or value, and are likely to be equivalent. In assessing their relevant benefits where a guarantee fee is paid, both parties will take it into account but not any tax deduction the investor will receive from paying it.

[456] This last sentence lies at the heart of Mr Farmer's argument. But, because it is based on an assumption which is directly opposed to the evidence, it also exposes its flaws. In fact, the proposition contradicts Mr Gibbs' answer to a question at trial about why the GPF might attract the Commissioner's attention as a tax avoidance mechanism. He said:

> … because of its novelty but also because of the **tax benefits that it generated because it was an extra deduction, or a deduction, and that generated a tax benefit which was shared** …
>
> [Emphasis added]

[457] All the contemporaneous documents support Mr Gibbs' admission.

[458] Westpac and its counterparties used a formula comprising standard elements to price dividend rates. Its most complete expression is found in Babcock & Brown's email to Westpac dated 4 June 1998 discussing Koch in these terms:

> dividend = [2(swap_rate+guar_fee)-swap_spread-bb_fees]/(1+1/0.67)
>
> and
>
> benefit = [(swap rate + guar_fee)*0.33 – swap_spread – bb_fees]/1.67
>
> bb_fees are our fees expressed as a % pa basis. Here about 20bp
>
> So, using the numbers on the latest printout,
>
> dividend = [2(8.15+2.85)-0.04-0.20]/(1+1/.67) = 8.73%
>
> and benefit = [(8.15+2.85)*0.33-0.04-0.20]/1.67 = 2.03%
>
> You may or may not be able to see from the above formulae that a 10 bp change in the swap rate equates to a 2*10/(1+1/0.67) = around an 8 bp change in div and a 10*0.33/1.67 = around 2bp change in benefit.

[459] The mathematical calculation was relatively simple. The dividend rate equalled the swap rate plus the 'guar fee' (minus some relatively minor spreads and fees) reduced by the counterparty's share of the tax benefits. The phrase 'guar fee' was shorthand for the GPF.

[460] The word 'benefit' plainly referred to the taxation benefit available to the bank. The components of the benefit were expressly (1) the swap rate or the marginal cost of Westpac's funds and (2) the GPF. Tellingly, the document made no reference to a credit margin or credit enhancement component. The swap rate was, I infer, deliberately chosen because it equated to Westpac's assumed actual cost of funds, providing an accurate measure for fixing the bank's borrowing deduction. On Babcock's calculation, the benefit available for equal division between the parties was 2.03% (the ultimate returns for each party were higher).

[461] Dr Fitzgerald's interpretation of Babcock's formula is instructive. He categorised it in this way:

$$\text{DISTRIBUTION RATE} = \frac{[2(\text{SwapRate}+\text{CGFP}) - \text{SwapSpread} - \text{BBFees}]}{1+\left(\frac{1}{0.67}\right)}$$

Ignoring the swap rate and Babcock's fees, the formula is then expressed as:

$$2\ (\text{SWAP RATE} + \text{CGPF})\ /\ (1 + \frac{1}{0.67})$$

$$\text{or } (\text{SWAP RATE} + \text{CGPF})\ (0.8024)$$

[462] It is the multiplier of 0.8024 which divided the tax benefits between the two parties. The benefits available for division were, I repeat, nominated as (a) the swap rate or marginal cost of Westpac's funds and (b) the GPF. On the New Zealand corporate tax rate of 33%, a multiplier of (1-0.33/2) or 0.835 would divide the tax benefits equally. Applying the swap rate used of 6.8150% and the GPF of 2.85%, the distribution rate would be:

$$(6.8150 + 2.85)\ (0.835) = 8.0703\%$$

[463] Mr Farmer had to confront the problems presented by the unambiguous inconsistency between Babcock's formula verified by Mr Gibbs' admission and his thesis. He observed that the participants introduced 'a bit of confusion … because sometimes they did not describe these things accurately' by failing to distinguish 'what was in the formula for what it was as a payment for a guarantee'.

[464] And in the course of a lengthy reconstructive explanation of the dividend rate, volunteered after a weekend's break in evidence, Mr Gibbs observed that the GPF was 'wrong in one crucial respect – it was mislabelled [it] should have been labelled a credit margin and that would have avoided a lot of confusion and stopped people … [concluding] … that the GPF was a deduction that actually generated a tax benefit that could be shared'.

[465] I am unable to accept these explanations; the documents convey certainty, not confusion, in omitting any reference to a credit margin or credit enhancement component. The documents unambiguously referred to the GPF or guarantee fee or its percentage equivalent. That finding is hardly surprising given Westpac's admitted failure to credit rate KCS; in the absence of that exercise it had no foundation for calculating a credit margin or credit enhancement component.

[466] Furthermore, the 'Expected Benefits' in the Koch Master Definitions document signed on 16 September 1998 were consistent with the parties' earlier

formulae. The document included most of the features identified by Babcock and Mr Gibbs when the transaction was finally priced earlier that month. The 'Expected Benefits' were defined in a specific document, described as the Master Definitions Schedule, as meaning:

> The amount per annum labelled in Schedule 1 as the "Koch Group Cost of Funds Savings" and for the TBNZ Group the amount per annum labelled in Schedule 1 as the "Investor Margin" on a pre-tax equivalent basis, each calculated using the methodology set forth in Schedule 1 attached hereto.

[467] Schedule 1 contained these tables:

Rates	
NZ Five Year Swap Rate (Quarterly)	6.955% pa
USD LIBOR	5.600% pa
Koch Group Loan Rate (USD LIBOR)	5.600% pa
Shares Distribution Rate	7.7177% pa
US Tax Rate	35%
NZ Tax Rate	33%
USDNZD Exchange Rate on Closing	0.51285%

Koch Group	
Aftertax cost of funds (USD)	2.567% pa
Pretax Equivalent	3.949% pa
Cost of funds (USD LIBOR)	5.600% pa
Koch Group Cost of Funds Saving	1.651% pa

Investor	
Aftertax Return (NZD)	5.760% pa
Pretax Equivalent	8.606% pa
NZ Five Year Swap Rate	6.955% pa
Investor's Margin	1.651% pa

[468] Schedule 1 recorded that the dividend rate of 7.7177% was based upon a swap rate of 6.955% (down from 8% in May 1998). It omitted reference to the GPF but that was known at 2.85%. The 'Koch Group Cost of Funds Saving' and 'Investors Margin', each of 1.6510%, aggregated 3.302%. That total figure was Westpac's taxation benefit available from the deductions claimed on both the cost of funds and the GPF.

[469] I agree with Mr Brown. The 'Expected Benefits' were the pre-tax equivalent of the difference between the tax free distribution received by the bank and its fixed costs after tax (i.e. 67% of the GPF, fixed leg of the swap and the swap spread). The dividend formula operated, as Mr Stanton confirmed, as the primary means by which the counterparty's share of Westpac's aggregate tax deductions were paid to it.

[470] On its face, consistently throughout its various manifestations, the formula unequivocally shared the tax benefits available from both asymmetries. The issuer's taxation deductions were not, Mr Farmer concedes, included within the formula. He still asserts, however, that they were shared 'in a way'. I assume he is referring to the arbitrage benefits generally available, as the first or cross-border asymmetry, in the issuer's right to deduct dividend payments.

[471] To the same effect, Mr Gibbs actually admitted to Mr Brown that he viewed the GPF as a convenient means of spreading or altering Westpac's benefit. He was aware throughout that an increase in the fee had that effect. He conceded that, first, a purpose of the GPF was 'to increase the benefit to the parties', second, both parties had an interest in the dividend rate being as high as possible within reason (following his acceptance of the parties having the same interest in the tax benefits available for sharing being as high as possible) and, third, the availability of the tax benefit provided by the GPF was a material factor in increasing the funding levels from NZD500m to NZD700m on Rabo 1, and from NZD500m to NZD800m on Rabo 2.

[472] Also, when discussing the various stages of the Koch transaction in March and June 1998, Mr Gibbs acknowledged that Babcock's formula 'indicated that the tax benefits were intended to be shared equally by Koch and Westpac'. I am satisfied that his acknowledgement, consistently with Babcock's 4 June 1998 formula, effectively extended to all taxation benefits, and was not limited to those available on exempt income.

[473] Mr Gibbs said also that 'for internal purposes, I probably used a mathematically similar formula' to Babcock's model when expressly incorporating the GPF into the Koch dividend rate. Again he acknowledged that it served to

‘divide the tax benefits’ between the parties. The tax benefits, I repeat, included Westpac’s rights to deductions for the cost of funds and the GPF.

[474] However, Mr Farmer maintained an attempt to lay an evidential foundation for his dividend composition thesis through Mr Gibbs despite his contrary admissions and the contemporaneous documents. Elsewhere at trial Mr Gibbs said he ‘considered it quite legitimate to separate out the value of a guarantee from the dividend rate’ (in his previous experience the value of group support was implicit in the lower dividend rate). Mr Gibbs said that the concept of ‘unbundling the elements of a financial instrument’ was not new to him. He was talking, though, about a different type of instrument, more akin to the special category of complex financing instruments identified by Dr Fitzgerald.

[475] The ‘unbundling’ concept did not emerge in any contemporaneous documents until an email from the Rabo 1 intermediary on 24 August 2000. That intermediary answered a request from a Westpac employee for reasons for the GPF’s payment (after that transaction had been entered into) in the context of the bank’s application to the IRD for First Data approval. The intermediary explained that unbundling ‘may be appropriate’ where the financier wanted to ‘sell down, sub-participate or credit enhance the exposure under the guarantee to a number of investors/participants’ (Dr Fitzgerald’s category). That objective was never present in any transaction before completion, and was never suggested to be by Mr Gibbs.

[476] Mr Gibbs accepted the novelty of a GPF – it had not featured in preference share transactions which he had previously undertaken. He then said that the subject transactions were ‘more transparent’ because Westpac was ‘deriving a dividend rate [that was] appropriate for the issuer, and … separately paying an agreed rate for a guarantee which [had] a value’ (i.e. discretely pricing the two separate legs). He sought to distinguish this transaction from the traditional public share issues discussed by Professor Schaefer, where ‘the value of the guarantee was embedded or lost in the dividend rate’.

[477] Mr Gibbs first introduced the notion of ‘creditworthiness’ between parent and subsidiary into evidence when discussing the proposed AIG transaction. He talked

about the figure of 2.95%, later known as the GPF, as reflecting 'the credit margin between a low quality and a very high quality (AAA) entity'.

[478] I must say that Mr Gibbs' explanation rings hollow. It bears the hallmarks of an ex post facto attempt to reconstruct the facts uncontrovertibly apparent from the primary evidence in order to suit a new theory. The credit margin concept now espoused by Mr Gibbs never featured in any of the contemporaneous correspondence or memoranda. That was because, I repeat, Westpac never credit rated KCS. Thus it had no benchmark against which to assess a margin.

[479] Mr Farmer's argument must fail for other reasons. First, Professor Schaefer was adamant in expressing orthodox financial theory that it would 'never be in the interests of the issuer to have a higher dividend rate'. However, Mr Farmer accepted that both sides would have an incentive to increase both the dividend rate and GPF, where the market spread in the formula and the fee were not set within a reasonable value range.

[480] That was what happened here, and on more than one occasion (for example, one CSFB email to Westpac, which was received without protest or contradiction, stated 'I'm looking for a greater distribution rate so we can increase the benefit to both parties'). More tellingly, as noted, Mr Gibbs volunteered to Mr Brown that both parties 'have an interest in the dividend rate being as high as possible, within reason'. This commonality of interest is inexplicable unless there was a mutual intention to share all, not a selection, of the consequential revenue benefits.

[481] The parties followed a pattern of unquestioning agreement to increases in the GPF. The increases were never based on a careful evaluation of changes in the credit risk, justifying an adjustment of the credit margin. And an increase in the GPF led inevitably to an increase in the dividend rate. While it also led to an increase in Westpac's income, the exemption which was available for sharing with the counterparty, that result, as Professor Schaefer confirmed, was otherwise commercially antithetical to the issuer given his underlying assumption that 'both parties had a simple reason to negotiate: the issuer wished to reduce the size of the dividend and the purchaser wished to increase it'.

[482] Second, the five examples of public issues of preferred stock given by Professor Schaefer provide little guidance. The Professor identified in each a margin conceptually comparable to the GPF as 'an opportunity rate'. However, he was unaware of the circumstances of the public issues. The circumstances are critical to establishing any similarities between those issues and these transactions.

[483] However, I assume that in accordance with standard capital raising practice the shares in Professor Schaefer's examples were issued in special purpose vehicles guaranteed by the parent, and the financial benefits attaching to the stock including the margin were fixed by the market and open to all who subscribed. That was not this case. It must be commercially unorthodox for the parties themselves to set the dividend rate, rather than the issuer fixing the price according to market parameters at the time of issue.

[484] Professor Schaefer's table is illuminating in this respect. None of the issuers enjoyed a credit rating comparable to Koch's AA+ status. The highest was CBA Capital Australia Ltd's A+. Its dividend included a credit margin of 0.75%, compared to what Westpac says was the appropriate rate of 2.85% for Koch. The extent of the credit margin differential between two highly rated entities as reflected in the Koch GPF is, on its face, inexplicable.

[485] In closing Mr Farmer made a disarming confession of conversion to his own thesis (for which I assume others must take responsibility). He suggested that judicial clarity would emerge upon realisation that the GPF did not 'in any way, shape or form find its way into the formula' and thus was not shared with the counterparty.

[486] Mr Farmer, for all his formidable powers of advocacy, was unable to persuade me to join him in the ranks of the converted. He will, I trust, understand my inability to accept that what was described as the GPF or its equivalent in all the dividend formulae was included by a mistake common to all participants, who in truth were instead including a credit margin for a company whose credit they had never rated, and that quite by coincidence the amount of that margin exactly matched

the amount of a guarantee payment made by the financier, which sat independently outside of or extraneous to the dividend payment.

[487] The uncontrovertible facts are fatal to an otherwise plausible sounding theory. The more I reviewed the evidence, the less tenable the argument became; if anything, it served to confirm the artificiality of the GPF and its use as a means of generating deductions for Westpac to share with the counterparty. In any event, I repeat Mr Farmer's acceptance that his argument would fail if, as I have found, the so-called credit margin component of the dividend formula was not fixed at a market rate.

(5) Cost of Funds

[488] The cost of Westpac's funds is the other contested pricing feature. It is directly relevant to the profitability of the transactions before tax. Again, this subject was not in contest in *BNZ Investments (No 2)*. The BNZ apparently accepted that the transactions were pre-tax negative or unprofitable before tax, that its cost of funds was at LIBOR or equivalent and that its funding formed part of the relevant arrangement.

[489] Again, considerable evidence and argument was committed to this issue. It led at times to confusion and, unintentionally, diversion from what may be the core question. Its scope is best distilled by summarising the competing contentions and then referring to the relevant evidence.

[490] Westpac operated a system of pooling its funds available for lending purposes. Experts on both sides confirmed Mr Coleman's evidence that, even on an international scale, these transactions involved very large amounts of money. The demands placed by one-off transactions of this magnitude were such, the Commissioner says, that the bank must have made special arrangements to raise finance for each. Mr Brown does not suggest that Westpac undertook matched funding – that is, matching each advance with capital raisings or borrowings of equivalent terms or amounts. Instead, he says, the bank broadly matched its specific requirements for each transaction by going to the international money markets.

[491] The funds raised internationally were borrowed at LIBOR and then converted immediately into New Zealand dollars, subject of course to an obligation to repay the principal with interest in the overseas currency. Mr Brown submits that the transactions would never have proceeded without Westpac's ability to access funds in this way. Each financing arrangement undertaken by the bank was, he says, an integral step in giving effect to each transaction.

[492] As a consequence, Mr Brown submits that LIBOR or, less often, BBR is the true measure of or proxy for Westpac's actual cost of funds. It also equalled the swap rate used as the benchmark or principal opportunity margin for calculating the dividend rate. On this basis, Westpac's cost of borrowing to fund the transactions equated to the return on the floating leg of the swaps.

[493] Westpac takes issue with the Commissioner's thesis, condemning it as simplistic and misconceived. Mr Farmer says the Commissioner has erred in treating the swap rate or fixed leg as a proxy for the bank's tax deductible cost of funds throughout each transaction. As a result, he says, the Commissioner's 'entire analysis of the subject transactions' is undermined. The best course, as was done with the bank's tax returns, Mr Farmer says, is to assess the actual cost of funding a transaction by averaging the deductions for the tax year. It is not possible, on this view, to allocate any particular borrowing to any particular transaction.

[494] Mr Farmer submits that the Commissioner's argument of general or synthetic matched funding is unavailable. A transaction is, he says, either match funded or not – there is no halfway house – and once a transaction is funded from a bank's treasury pool, as these were, no specific funding cost can be attributed to it. Mr Farmer asserts that the Commissioner cannot identify a direct link, for example, between funds raised from a third party market source and funds provided to the counterparty.

[495] Mr Farmer accepts, nevertheless, that the financing of Koch and CSFB through TBNZ's retained earnings might have created a gap requiring other borrowings. But that, he says, would be easily managed within Westpac's treasury. And when funds were raised from external sources, they immediately found their way into the bank's general pool of funds.

[496] I propose to address this issue in two stages. The first is to determine how Westpac sourced its funds. The second is to fix the appropriate cost of those funds.

(a) Source of Funds

[497] How did Westpac source its funds for these transactions? Mr Mahes Hettige was the Westpac treasury employee directly responsible for arranging funds. He commenced employment as a senior manager in the bank's treasury funding and corporate structure section in October 1996. He remained there until July 2002.

[498] Westpac did not call Mr Hettige to give evidence at trial. Instead it relied upon its current treasurer, Mr Stuart MacDonald. He did not join the relevant treasury team until May 2000, after these four transactions were entered into. Mr MacDonald's evidence was thus in the nature of commentary or reconstruction, and of limited assistance.

[499] Mr Hettige participated in a voluntary interview with senior IRD employees in July 2004. A transcript was produced by consent late in the trial. Mr Hettige's answers to questions served to explain and confirm the contents of a number of contemporaneous documents.

[500] In summary, Mr Hettige said:

(1) The predominant function of his treasury team was to manage balance sheet, funding and risk management, including interest rate risks, arising from assets and liabilities on Westpac's balance sheet. The bank's trading activity on financial markets fell under a separate management structure;

(2) His direct function on Koch and CSFB was to co-ordinate funding, manage liquidity characteristics arising from the transactions and ensure that they were within the bank's policy for pricing in terms of internal arm's length pricing (that is, settling the notional charge of funds to other business units such as structured finance). He viewed

transactions arranged by the structured finance unit as no different from any others which would be written in the New Zealand market or with an offshore client;

(3) The structured finance unit usually gave treasury two or three months notice of its requirement for funds. Treasury would then view the terms of its overall consolidated cashflows, which changed substantially on a daily basis. Treasury's concern was to ensure that these transactions did not 'actually create a liquidity concentration' – where a large amount of transactions are maturing but the bank was unable to cater for them in terms of cash inflow;

(4) In all USD pricing, treasury would look at its benchmark pricing which was at USD LIBOR. Where, as here, funds were required for a longer term transaction of five years, treasury considered financing requirements 'in terms of a three year behavioural characteristic for liquidity modelling'. There was a 'cumulative mismatch' between Westpac's capital raising and funding requirements for these transactions;

(5) Westpac operated a transfer pricing system for its business units. Treasury charged a term liquidity premium (TLP) from a balance sheet management perspective, based upon what 'reflected a term funding element, term funding cost';

(6) Once funding requirements were identified on a consolidated basis, Mr Hettige would interact with the bank's London desk which predominantly funded its USD requirements. That office engaged in capital market activities including general deposit taking. Its focus was on 'the most suitable maturity from a liquidity perspective … and the pricing'. When they were settled, the objective was to ensure that the funds were available on time within the New Zealand jurisdiction;

(7) Westpac had a number of sources for USD. Once they were settled, the bank sold the foreign currency through its financial markets to generate the requirements for the underlying investment. Mr Hettige's primary responsibility was to source those dollars.

[501] Mr Hettige remembered both Koch and CSFB when interviewed in 2004. He confirmed that TrustBank had retained earnings of about $1.4b on deposit with WBC following their merger. NZD400m was earmarked for Koch. Its withdrawal from the aggregate deposit left a gap in the bank's pool of funds. Westpac funded this shortfall from its London desk with USD. Its financial markets section then swapped that currency into NZD which were used to replace the TBNZ deposit.

[502] CSFB was initially funded in USD. It was, Mr Hettige said, 'a large transaction'. A limited amount of NZD were available from the local wholesale and retail market. According to Mr Hettige, Westpac was unable to fund the NZD equivalent of USD200m domestically, and the US dollar availability through the London office was 'the most liquid pool of funds that we could use at that stage'. The transactions 'created a funding impost' which was satisfied by USD.

[503] Mr Hettige was referred to a number of documents. In one, in particular, he expressly confirmed the initial funding of USD200m raised by Westpac to finance Koch (that is, the disputed dotted line entry shown in Appendix 1, referred to in [24] above). Other documents confirmed Mr Hettige's account. For example, in his internal treasury email dated 16 June 1998, Mr Hettige said:

> I am currently in the process of negotiating with [g]roup [t]reasury – Jonathan Minor – an access to a term pool of USD which will hopefully enable [us] to fund both the CSFB and the KOCH deal. The pricing on the draw-downs of these will have to be set at an arm's length basis. I envisage we will fund the two deals with one year term USD funds drawn from this pool and then refinance them on a rolling one year basis.
>
> The need for term funds is generated by our desire to better manage the term structure and the liquidity of banks balance sheet. We are uncomfortable with accelerating our short term USD pool volumes when we are in fact funding longated USD. Going forward term foreign currency assets will be funded in a prudent long term foreign currency borrowing (for term mismatch that the Treasurer perceives to be desirable). If the underlying asset folds before maturity, the foreign currency denominated funding will

> be swapped to New Zealand for the remaining NZD for the remaining maturity.

[504] In the same email Mr Hettige confirmed, in highlighted words, that:

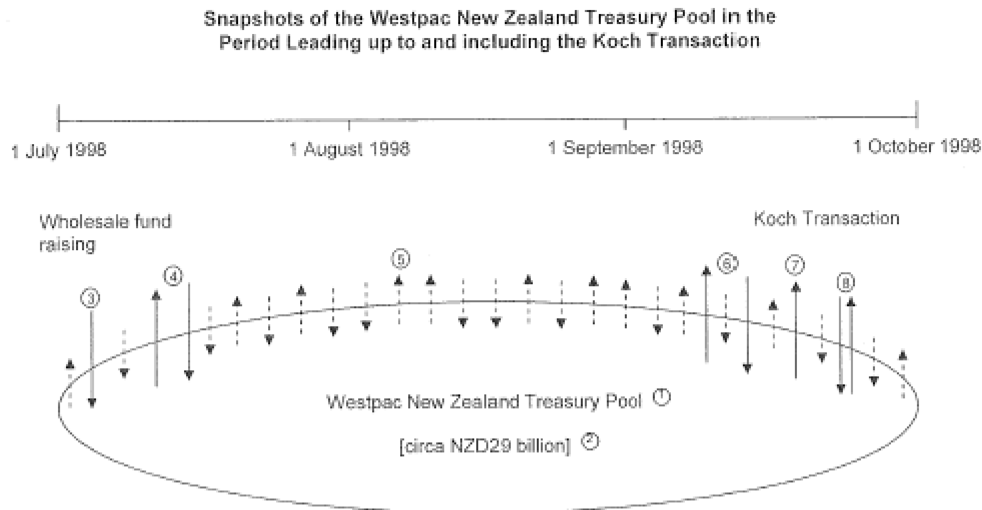
> The pricing on the deals in either event will be 3 month USD Libor (which is pricing inclusive of 12bp AIL) + TLP of 5bp (which is the term liquidity premium assuming a three year behavioural term funding profile of the deals).

[505] Mr MacDonald, by way of reconstruction, confirmed that the bank was a net borrower of funds because of its New Zealand customers' borrowing habits; wholesale funding was used as a balancing figure to cover any net shortfall; the relevant cashflow forecasts noted the extra funding demands for these transactions; and the bulk of Westpac's wholesale funding requirements were satisfied from offshore markets, for example through Euro commercial paper and Euro medium term notes which are typically issued at US LIBOR, sometimes plus a margin.

[506] Westpac does not dispute this evidence, including apparently that it raised USD200m to finance Koch. What Mr Farmer says, however, is that the Commissioner's argument proceeds on a misunderstanding; that is, a failure to recognise that treasury's funding arrangements with offshore markets are entered into to fund the bank's entire balance sheet, not individual transactions regardless of their size (accepting that a large transaction may have a noticeable impact on the bank's overall funding needs and will be taken into account when a capital raising is undertaken). Once obtained, funding from an offshore market is immediately swapped to generate NZD pricing with the proceeds forming part of the fungible treasury pool or bucket.

[507] Mr Farmer portrays the Commissioner's approach as 'the antithesis of common sense'. He says it is flawed in seeking to 'identify a particular cost attributable to a particular piece of income'. The Commissioner, he says, does not appreciate the operation of a sophisticated bank treasury operation. Mr Farmer accepts that the prospective demands of the transactions might well have, to an extent, contributed to treasury's decision to source US dollar LIBOR funds for the pool at a particular time. But such funding was not specifically for those transactions.

[508] And, once obtained, Mr Farmer says, the funds were swapped into NZD and 'swallowed up in the treasury pool'; when required for actual settlement of a transaction, the money was drawn from the pool at that date after conversion by an FX purchase where necessary. To provide a graphic illustration of his argument, Mr Farmer produced this diagram:



1. The pool is managed in NZD [see eg. Hettige transcript page 45/32–37 and Croft [5.17]]. It is comprised of funding from all sources, ranging from equity, to low interest cheque accounts, to amounts raised in the wholesale debt markets [Macdonald [3.6]]. Treasury's objective is to fund at an overall margin below NZD BBR [Macdonald [3.10]].

2. Average total funds in the period 1 October 1998 – 31 December 1998 was NZD29.1 billion [Van Zijl Appendix 2]. The figure for the preceding quarter would have been comparable.

3. The only significant wholesale fund raising in the period was a USD500m Floating Rate Note (**FRN**) issued at USD LIBOR (issued on 7 July, with settlement on 30 July). This fund raising was in response to general balance sheet growth and the overall demands of the pool, which included the impending Koch transaction [Macdonald [3.11]-[3.18], EXCT T918/4 – T919/19 and REX T942/27 – T944/20]. It represented only 3.5% of the bank's total average funds at the time (ie. NZD1 billion / NZD29 billion = 3.5%).

4. The USD raised through the FRN in ③ above was swapped into NZD [Hettige transcript page 30/9-17 and 31/27-33].

5. The small dotted arrows depict the tens of thousands of inflows and outflows from the pool during the period, both in relation to the bank's wholesale operations and its retail business.

6. A series of spot foreign exchange transactions was undertaken in the period 15-17 September, the effect of which was to convert NZD pool funding into USD264m [Macdonald [5.6]]. These transactions did not raise funding [Macdonald [5.6] and Croft [7.11]-[7.12]].

7. On 17 September 1998, after WBC repaid NZD400m of TBNZ's deposit and TBNZ Investments was capitalised (via TBNZ Developments), NZD390m was paid to KCS for the KIWI Preferred Shares.

8. Also on 17 September 1998, KCS paid NZD390m to WBC in exchange for USD200m under the Basis Swap. The swap did not raise funding [Croft [4.2(a) and (b)]].

[509] Both sides cited authority but little of it was on point for the obvious reason that this is an intensely factual question. Almost without exception, the cases were concerned with challenges to the Commissioner's assessments of profits or gains under specific statutory provisions: see, for example, *Lowe v Commissioner of Inland Revenue* [1981] 1 NZLR 326 (CA) where the authorities are reviewed. The issue has been whether the Commissioner has correctly assessed profits to tax. This case is in a different category.

[510] Mr Farmer devoted particular time in closing to *New Zealand Co-operative Dairy Ltd v Commissioner of Inland Revenue* (1988) 10 NZTC 5,215. However, that case was decided in a very different context. The taxpayer had for many years allocated interest on a large common pool of funds between two trading activities on one basis which the Commissioner accepted for some years but later rejected. By the time of trial it was common ground that the nature and size of the taxpayer's activities and the manner in which it managed its funds prevented any direct correlation between particular borrowing and particular assets: at 5,230. I simply observe that what was common ground in the *New Zealand Co-operative Dairy* case, and was not ultimately the subject of a contested judicial determination – that is, the absence of matched funding – is not common ground here.

[511] Westpac did not, of course, undertake strictly matched funding for these transactions in a technical sense. But labels, or a postulation of absolutes excluding scope for intermediate positions, are unhelpful. I accept that all or part of funding raised from an offshore source could not be physically traced to a particular transaction. And I accept that the funds went into Westpac's treasury pool.

[512] But the funds raised by Westpac at LIBOR added to or topped up the pool's contents to satisfy the demands of a specific transaction. The bank assumed a discrete obligation to meet the cost of the loan for its term; but for the transaction, I am satisfied it would not have assumed that liability.

[513] And, of course, Westpac was bound to repay in the foreign currency when due. It is not unreasonable to attribute a specific interest liability on one side to a

specific and related transaction on the other. There was a real causative link or nexus. Whether the two exactly matched does not matter.

[514] Koch is an example. Westpac raised USD500m on 30 July 1998, in response to general balance sheet growth, pool demands and, Mr Farmer accepts, the requirement to finance Koch – USD200m was required for that purpose. The term of three years coincided with the actual duration of Koch (although Koch commenced six weeks later, on 17 September 1998, and terminated on that date in 2001).

[515] Mr Farmer is correct that its general pool of funds was the immediate source of the Koch funding. However, the underlying transactional nexus was with USD200m of the USD500m raised from offshore six weeks earlier. That distinct part of the capital raising was, in my judgment, the true source of the funds, and the interest cost payable at LIBOR is directly attributable to Koch. Without this underlying transaction, I am satisfied that Koch would never have proceeded.

[516] I am satisfied that there was, first, a direct correlation between Westpac's borrowing in offshore markets and satisfaction of its financing obligations on each transaction; and, second, each transaction was of such magnitude, and potentially of such duration, that the bank had to arrange funds specifically, to be sourced from international money markets through its London office, to ensure sufficient capital was available to settle with the counterparty on the due date. This finding is consistent with evidence from Westpac's expert, Mr David Croft, that 'major one-off transactions' are the exception to the 'no matching' rule. Westpac's offshore borrowing, raised at market rates, was the source of its funds for Koch.

(b) Actual Cost and Pre-Tax Profitability

[517] What was the actual cost of Westpac's funds for each transaction? And consequently, were the transactions pre-tax profitable? The bank says that the only cost of funds which can and should be attributed to a transaction is its overall average tax deductible cost of funds. The Commissioner counters that, if this

proposition is accepted, the calculation should take account of the cost of all funds including equity.

[518] Mr Farmer submits that Westpac's assumptions of the type made in Mr Gibbs' 18 May 1998 SFC memorandum (that funding of the transactions would be at market rates) were relevant only to issues of transfer pricing, internal management accounting, transaction pricing, measuring the profitability or performance of the structured finance unit and tax shelter allocation. In other words, the bank's treasury group managed all its funds, and notionally charged other business units at the relevant inter-bank rate as if they were outside borrowers. The actual economic impact of the transactions on Westpac as a whole, that is their profitability or otherwise, would primarily be determined by treasury's success or otherwise in managing the bank's total funding pool.

[519] It is true, and Mr Farmer accepts, that the profitability of the transactions to both parties was improved by the existence of tax benefits. But that factor is irrelevant, he says, to the underlying truth: that if Westpac's actual cost of funds is used as the appropriate benchmark each transaction was pre-tax positive for Westpac – another sign of its inherent commerciality.

[520] Westpac relies on Professor Van Zijl. He has assessed the bank's average tax deductible cost of funds for the duration of Koch at 4.19%; for CSFB at 4.34%; and for each of Rabo 1 and Rabo 2 at 4.29%. On this basis Westpac shows that each transaction produced a positive pre-tax position. For example, with Koch:

(1)	Kiwi dividends	7.7177%
(2)	Average cost of funds	(4.19%)
(3)	GPF	(2.85%)
(4)	Pre-tax position	0.6777%

[521] By contrast, the Commissioner calculates a pre-tax negative position on Koch as follows:

(1)	Kiwi dividends	7.7177%
(2)	Swap rate	(6.8150%)
(3)	GPF	(2.85%)
(4)	Pre-tax loss	(1.9473%)

[522] The answer to the dispute about Westpac's actual cost of funds and the pre-tax profitability of the transactions is largely determined by my previous finding. In this respect I accept that, at the relevant times, Westpac had access to a significant amount of funds at well below market costs. Principally they were low interest current accounts and retail term deposits; and their availability allowed the bank to fund its daily operations at below LIBOR or BBR rates.

[523] I found Mr Croft's evidence for Westpac most informative on this subject. He was very familiar with the transfer pricing system for funds operating between a bank's treasury and its business units. In his experience, on a practical level, it is 'very difficult to use the average cost of funds' as the measure of a transaction's profitability. By comparison, Mr Croft considered that by applying the marginal opportunity cost, which matches the external rate of borrowing, a bank is able to discretely assess a transaction's profitability. The institution's cost of funds as a whole reflects liability gathering activities whereas business units are performing the separate function of extending funds and financing transactions.

[524] Mr Croft's evidence articulated the practice adopted by Westpac's SFC to assess Koch's profitability when approving Mr Gibbs' 18 May 1998 memorandum. All Mr Gibbs' profit calculations used the swap rate, which equated with LIBOR or BBR. It was plainly the most reliable benchmark. It was important, as earlier noted, that the parties adopt an accurate measure of Westpac's cost of funds for the purpose of calculating the deductions for borrowing costs available for division. Mr Gibbs did not attempt to engage in an exercise similar to Professor van Zijl and calculate the bank's average tax deductible cost of funds for the previous year.

[525] The swap rate may not have equated with Westpac's average tax deductible cost of funds at the time, as established by a careful retrospective assessment. And it may have equated with the notional cost charged by treasury to another business unit. However, I am satisfied that Mr Gibbs' 18 May 1998 proposal, and the SFC's subsequent approval, treated the swap rate as the true or actual cost of the bank's funds. The bank's four transaction summaries all adopted the five year swap rate, and the documents clearly establish that this was the most accurate measure for allocating tax shelter, which I shall discuss later.

[526] Westpac is probably correct that it was at the time of settlement impossible to determine whether a particular transaction would in fact be profitable. But that is not the test. This inquiry is concerned with the state of affairs existing when Westpac approved Koch in June 1998 and entered into the transaction in September. Was it then viewed by Westpac as likely to be pre-tax profitable?

[527] The bank's reconstruction undertaken 10 years later, to undermine the reliability of its own contemporaneous assessment upon which it relied for all material purposes, is not relevant. As Mr MacDonald advised, Westpac does not undertake a retrospective assessment of a transaction's profitability by reference to the actual cost of funds. The bank does not have the resources or the time. So it required an objective criterion for measuring the performance of a proposed transaction before giving approval. And, Mr MacDonald said, it is in any event 'always forward looking'.

[528] Accordingly, I am satisfied that Westpac's notional or marginal cost charge to the structured finance unit equated with its assessment of the actual costs of the funds applied in each transaction – that is, at a floating LIBOR rate – and its profit calculation, as found for example in Mr Gibbs' 18 May 1998 memorandum, was and remained the bank's best estimate. Significantly, also, the bank used the terms of the SFC's approval as the basis for calculating tax shelter availability; any major error could have jeopardised its final taxation position.

[529] Furthermore, I am satisfied that Westpac entered into these transactions in the expectation that they would be pre-tax negative. Mr Gibbs' 18 May 1998 memorandum proceeded on the premise, common to Koch and all other transactions, of pre-tax negativity (see [105]-[107] above). He calculated that Koch would contribute a net loss to Westpac's profit and loss account of $9.04m. He reached this figure by deducting the GPF of $11.4m and funding costs of $32m from dividend income of $34.36m. Like the Commissioner, whose approach Mr Farmer consistently condemned, Mr Gibbs treated Koch as comprising three not four legs.

[530] Mr Stanton adopted the same approach as Mr Gibbs, verifying his method of calculating the financial elements of the actual transaction as follows:

	Floating Payments	Percentage Returns (%)	Absolute Returns (NZ$'m)
Dividend, on the Kiwi Preferred Shares		7.72	30.11
Plus: the floating leg of the swap, receivable by WBC from KCS	US$ libor		
Less: funding costs allocated to the transaction	(US$ libor)	-	-
Less: the fixed leg of the swap, payable by WBC to KCS		(6.82)	(26.60)
Less: guarantee procurement fee payable to KCS		(2.85)	(11.12)
Pre tax profit/(loss)		(1.95)	(7.61)
New Zealand tax: Income non taxable Deduction against other income liable to tax (6.82 plus 2.85) x NZ corporate tax rate of 33%		- 3.19	12.44
Westpac post tax benefit		1.24	4.83

On Mr Stanton's calculation, Westpac's actual pre-tax loss on Koch was $7.61m. But, once taxation deductions of $12.44m were taken into account, its post-tax benefit was $4.83m.

[531] I reject Mr Farmer's proposition that the result of acceptance of the Commissioner's argument is a 'fiction … [which] leads to false conclusions as to the commerciality of the transactions'. In effect Mr Farmer's sustained criticism is of the Commissioner's adoption of Westpac's own contemporaneous analysis of profitability.

[532] I accept, of course, that investors take into account the incidence of taxation when deciding whether to proceed. However, it is particularly relevant to this inquiry that Westpac expected all transactions to result in a pre-tax loss or was indifferent about it. Instead it focused upon deductions being available to the bank to offset against income and convert a pre-tax loss into a post-tax profit. Mr Farmer himself concedes that a pre-tax loss on the transactions was inevitable if I accepted, as I have, the Commissioner's marginal cost theory.

(6) Financial Consequences

[533] The next and logically successive subject is the financial consequences of the transactions (as distinct from whether they had a commercial purpose or effect) after taking into account the incidence of taxation.

[534] In summary, Professor Evans' undisputed evidence about Koch was as follows:

> (1) Westpac received tax exempt distributions or an after-tax revenue stream of 7.7177% on NZD390m;
>
> (2) Westpac paid the GPF of 2.85% and the fixed interest rate on the currency swap of 6.815% on NZD390m. Both expenses were deductible. Applying a tax rate of 33%, the post-tax cost of these payments to Westpac was 1.9095% and 4.5661% (totalling 6.4756%) respectively;
>
> (3) Westpac paid a letter of credit fee to Koch of 0.125% on NZD195m (equivalent to a fee of 0.0625% on the total of NZD390m). Again applying a 33% tax rate, the after-tax letter of credit fee was 0.0419%;
>
> (4) The interest payments on the currency swap netted off.

[535] Professor Evans calculated Westpac's post-tax profit on NZD390m at 1.2003% (7.7177% - 6.4756% - 0.0419%). This figure is a little above that calculated by Professor James Hodder for Westpac. He applied BBR instead of LIBOR for the appropriate interest rate. He concluded that the bank would receive an 'attractive return' of 1.1065%.

[536] In Dr Fitzgerald's opinion, Westpac's post-tax margins on all transactions, of well over 1% or 100 basis points, were 'extraordinarily high compared with

conventional levels, even on very complex structured transactions between knowledgeable parties'.

[537] On Professor Evans' assessment, Koch's benefits were similarly favourable. Koch received payments of 2.85% for the GPF, 6.815% for the fixed interest on the currency swap and 0.0625% for the letter of credit fee. All were assessable at a corporate rate of 35%. After-tax receipts would have been 6.3229%.

[538] Koch's dividend payment of 7.7177% and its share of the letter of credit fee of 0.125% on NZD195m were deductible. The after-tax payment for the dividend and letter of credit fee were therefore 5.0978%. The payments under the currency swap netted to zero. On an after-tax basis Koch's profit was 1.2251% (6.3229% - 5.0978%).

[539] Professor Saunders confirmed the conclusions reached by Professors Evans and Hodder. On his calculation Westpac's pre-tax loss on Koch was -1.9473% but its after-tax profit was 1.24215%. Professor Saunders also concluded that the transactions represented an after-tax return on assets in the range of 1.847% to 2.9114%. These were, he said, uncommonly high given that similar returns for most large banks had been just above 1% in then recent years. For Westpac, its overall return on assets varied between 0.91% and 1.04% from 1998 to 2000, demonstrating significantly higher returns from these transactions than those generated on average.

[540] These unusually high levels of return must be viewed in the light of one other factor. Dr Fitzgerald and Professor Saunders' uncontested evidence was that the cost of funds for a higher rated institution is generally less than for a lower rated institution. This is a function of orthodox market credit rating. So, Dr Fitzgerald said, it is generally not possible for a lower rated entity like Westpac to lend to a higher rated entity like Koch at the margin (in conventional money and fixed income markets) and earn any or an adequate return on its capital. It was not economically feasible for Westpac, for example, to raise funds at a normal margin above LIBOR and then on-lend to Koch at a profit.

[541] Mr Farmer accepts that evidence is correct 'all things being equal'. But here he says it is 'too simplistic and superficial to be meaningful'. It is not, he says, an invariable prerequisite for a bank to have a better credit rating than its customer to be able to provide advantageous funding rates. In this case he says the funding costs are achieved from 'the particular structuring' that was available to the parties. By that, he was referring to the taxation structure.

[542] Dr Fitzgerald accepts that his thesis is subject to a qualification – that is, any banking institution like Westpac will have access to certain types of funding at significantly below market rates; for example, funds held overnight or on short term deposit. However, I have already concluded that Westpac was funding these transactions from borrowing at LIBOR.

[543] Mr Gibbs himself acknowledged in a note to Mr Mataira on 6 May 1997 that a higher rated 'counterparty can borrow at lower rates than Westpac and we must offer more than a 50/50 split to be competitive'. Mr Farmer says that Mr Gibbs and others were not privy to Westpac's treasury operations and its ability to fund its global pool below LIBOR. Nevertheless, Mr Gibbs' observation is consistent with the weight of Westpac's contemporaneous evidence.

[544] According to Dr Fitzgerald, a highly rated entity, even one enjoying a AAA or AA status, would be happy with a fixed or floating rate issue which might raise funds at LIBOR minus 30-40 basis points. Margins in excess of this figure would equate to borrowing at well below Government rates. The counterparty's post-tax profit margins equate with receipt of funds at significantly sub LIBOR rates. In some cases the counterparty borrowing was at 1-2% below LIBOR. Professor George and Mr Croft, with a degree of apparent reluctance, accepted the significance of such benefits.

[545] Also I accept Professor Saunders' opinion that Koch was not a market driven transaction. Its pricing was not determined by market conditions. In September 1998, according to Professor Saunders, the rate on AAA rated debt was only 6.40%; on BBB rated debt it was 7.09%. Koch was, as noted, rated AA+. The dividend rate on the Kiwi preference shares was set at 7.7177%. The Kiwi shares were issued at a

rate which exceeded AAA market rates by 1.3177%, and BBB rates by 0.6277%. The rate on AA rated securities was then 6.41%. Thus Westpac's yield on the Kiwi shares exceeded market by 1.3177%.

[546] I am satisfied that Westpac's shared use of its taxation benefits, including the deductibility of its expenses, had the effect of converting all transactions from a calculated position of pre-tax negativity into post-tax profitability, and that the financial returns for both parties as a result significantly exceeded those otherwise available on the market.

(7) Tax Shelter or Capacity

[547] The use of Westpac's tax shelter or capacity – that is, the availability of other income or profits against which Westpac could deduct expenses – loomed large throughout the evidence and argument. Its existence is another factor relevant to the avoidance inquiry. The Commissioner says the transactions were designed for the purpose of optimising the bank's tax shelter capacity or consumption. Indeed, Mr Gibbs accepted that that was the structured finance unit's primary role. Or, putting it in the converse, its function was to limit taxation liability (according to the unit's 1997/8 strategy paper it was 'to add value to transactions by optimising their tax effects for the benefit of the bank'). In time these transactions became Westpac's largest consumer of tax shelter.

[548] The relationship of tax shelter to these transactions first emerged in a memorandum from Mr Mataira dated 12 June 1997. He inquired whether it was necessary for the bank to implement a tax shelter allocation policy to limit the number of structured deals. It was then Mr Mataira's view that the best interests of the bank and its shareholders were to pay as little New Zealand tax as legitimately possible.

[549] As Mr Brown submits, Mr Mataira's memorandum signalled the beginning of the formulation of Westpac's tax shelter strategy. It focused on the simple mechanism of generating deductions (sometimes called losses) which would be available for offset against other income. Mr Mataira was aware that the three

principal deductible expenses to be incurred in these transactions were costs of borrowing, the GPF and interest shortfalls on the swaps.

[550] Mr Gibbs volunteered that the availability of tax shelter was a critical factor in deciding whether to enter into Koch. As noted, it was assumed, at least for management accounting and profit calculation purposes, that all transactions would result in a net loss (i.e. taking account of the deductions) before tax each year. Mr Gibbs' 18 May 1998 SFC memorandum is a good example, highlighting that:

> Tax losses will arise in [i]nvestor due to the dividends from [i]nvestor being exempt while the [GPF] and any net swap losses will be deductible. These losses will be grouped against the [b]ranch's income in consideration for payments equal to 33% of the amount of the losses.

[551] Mr Gibbs also observed that the projected amount of the group's tax shelter limited the volume of transactions with assumed pre-tax losses which the bank could undertake. Accordingly it was important for a transaction to be accommodated within the group's available tax shelter, with the after-tax profit also being sufficient to justify its use of the shelter.

[552] Allied with tax shelter was the concept of Westpac's ETR. As noted, that is the ratio, expressed as a percentage, of the bank's reported tax expense to its profit before tax. Some of the bank's witnesses, including Messrs Gibbs and Mataira, compared it with the legal tax rate of 33%. Importantly, the ETR was not the same as Westpac's actual tax liability; the figure included tax paid in foreign jurisdictions that could be attributed to the bank (such as on consolidation). The ETR can be calculated from the public financial accounts. Westpac continually monitored its ETR, to ensure that its reported level of tax expense was, as Mr Mataira said, consistent with how it viewed its standing in the marketplace compared with reporting by its competitors.

[553] Mr Gibbs accepted that all the transactions could potentially reduce Westpac's ETR by more than the reduction in accounting profit before tax, which occurs because the bank makes a cash loss. The reported tax expense reduces because the bank claims deductions for its expenses but does not pay tax on income in these types of transactions.

[554] Westpac was always conscious of its ETR. The bank was anxious not to reduce it unduly because of its reputational effect; it wanted to appear as a good corporate citizen paying a responsible level of tax. For that reason, Westpac's chief executive officer imposed a minimum ETR for the Westpac group of 25% in 1997. All these transactions took that factor into account. However, management progressively allowed the ETR to fall, first to around 20% in about May 2000 and then to the 'high teens'.

[555] The growth in these transactions caused a steady decline in Westpac's ETR. In 2001 Westpac had made an overall loss of $71m (although the ETR was still 11%). Mr Shewan, as Westpac's taxation advisor, expressed his discomfort with this situation. Mr Mataira had earlier set up a 'buffer' to protect the bank's tax shelter against unforeseen circumstances, in the nature of a contingency provision to meet losses of this type and nature. Mr Mataira was concerned that ongoing demands placed upon the bank's tax shelter by the structured finance transactions would reduce or exhaust the buffer. The bank would then be left without reserves for a sudden or unexpected loss elsewhere in its operation.

[556] There was a degree of ongoing tension between the structured finance unit, which wanted to increase the volume and amount of these transactions, and Mr Mataira's taxation management, whose function was to impose restraint. This friction is apparent in contemporaneous documents. It is unnecessary to go into detail. Some examples will suffice.

[557] On 2 February 1999 Mr Mataira recommended an immediate reduction in the allocation of tax shelter to $100m annually and required all structured finance transactions not yet booked be able to be unwound within six to 12 months. On 5 February a structured finance member in Australia, Mr Mark Woodward, advised that Koch, CSFB, GE, First Data and BANA (the deal was then closed) were using around $140m shelter.

[558] Later, on 17 June 1999, Mr Gibbs noted an increase in the projected tax shelter for 2000 and 2001. He sought approval to use around $85m-$90m. On 29 February 2000 Mr Mataira noted that tax shelter projections for the transactions,

including by then Rabo 1, exceeded the allocated $150m shelter. Mr Gibbs was seeking a further allocation to enable Rabo 2 to proceed. That transaction, along with HSBC, was forecast to increase tax shelter usage by April 2000 from about $190m to over $320m. A decision was made on 19 December 2000 that tax shelter use for 2001 should not exceed $300m.

[559] Nevertheless, within a month, Ms Osborne requested a further $50m of tax shelter for the 2001 year, noting that if necessary termination rights could be invoked. Increases in the sizes of the transactions and in the amount of shelter available continued throughout that year and in 2001. The same pattern of tension remained. But transactions of increasing size were entered into. For example, in August 2001 Westpac terminated CSFB at $500m, which it substituted with BANA 1 at $1b.

[560] In January 2001 Mr Mataira had requested preparation of a detailed tax shelter paper for the seven existing transactions (Koch, First Data, GE, CSGB, Rabo 1, Rabo 2 and HSBC). The calculation showed total tax shelter usage for the year ended 30 September 2000 of $201.664m. However, for the 2001 year tax shelter usage was projected to increase to $302.178m. Both were against a constant tax cap for the year of $250m.

[561] The calculations for Koch were as follows:

	Koch
Year Ended 30/09/2000	
Principal	389,977,576
Maturity Date	17-Sep-03
Unwind Clause	up to 50% on Sept 2000 or 2001 & remainder on 3rd or 4th anniversary
Dividend Rate	7.9177%
Swap Fixed Pay	6.955%
Guarantee Fee	2.85%
TLP	0.06%
Percentage of Year on Books	100%
Dividend Income	46,085,455
Swap Cost	-27,122,940
TLP Cost	-233,987
Guarantee Fee	-11,114,361
Net Margin	**7,614,167**
	1.95%
NPAT	**5,101,492**
Tax Shelter Useage	
Y/E 30/9/2000	
Swap Fixed Pay	27,122,940
Guarantee Fee	11,114,361
Total Tax Shelter Useage	**38,237,301**
Return on Tax Shelter (ROTS)	**13%**

[562] These calculations appear to contain material errors. They recorded dividend income of $46.085m, being 7.9177% of NZD390m. But the actual return was, as earlier shown, much less. It was $30,877m. The net margin was not a profit of $7.614m but a pre-tax loss of $7.594m.

[563] In March 2002 Mr Mataira understood that the bank's pre-tax profit for the year ended 31 September 2001 was about $610m; and that an overall tax loss of $25m would be incurred. He requested Mr Shewan's advice on the amount of tax that it should be paying and on an appropriate response to the market if the actual level of tax paid became widely publicised, on the ramifications with the public and the Commissioner in this event, and the level of tax which should be paid (as opposed to reported) for an organisation of Westpac's size.

[564] Mr Shewan recommended that Westpac pay $30m-$40m annually (tax shelter consumption at that time was around $346.9m), even though that sum

represented a rate of only 6.5% against the reported profit. Shortly afterwards Westpac unwound both Rabobank transactions, substituting them with a $1.5b deal with Citibank and a further $1b deal with Bank of America.

[565] Mr Brown submits that by early 2002, when it sought Mr Shewan's advice, Westpac faced a dilemma 'as a result of the size of the losses deliberately contrived' by the transactions. He says that it was not a case of choosing how to structure a particular transaction in a tax effective way, but a case of choosing whether to pay tax at all. Mr Brown says the only meaningful choices exercised by Westpac were, first, whether to enter into a transaction at all and, second, the quantum of the losses which it wished to create, dictating in turn the size and number of transactions entered into.

[566] Mr Farmer downplays the Commissioner's emphasis on tax shelter and ETR. He says it is inherent in the economics of tax effective transactions that their profitability depends on one party being able to use the tax benefits available, whether in the form of deductions or credits – these benefits only have value if they can be realised by a reduction in tax liability. For example, it is central to the economics of redeemable preference share financing that, as in *BNZ Investments (No 1)*, the investor makes borrowings which it can then deduct against its other taxable income. In this case, he accepts, the bank managed its tax shelter capacity, but simply to ensure that it had sufficient other taxable income against which to claim deductions.

[567] In summary, Mr Farmer says that Westpac's management of its tax shelter capacity and ETR simply involved explicit consideration of what occurs when a taxpayer incurs net losses available to be offset against gross income, and points to the fact that Wild J in the *BNZ Investments (No 2)* case summarised at some length competing submissions on the point but did not give the bank's use of tax shelter any great weight: at [437]-[455].

[568] I will return to this subject when evaluating all the factors relevant to the tax avoidance inquiry. However, for now I note that Westpac's use of tax shelter or capacity is in a different league from the examples given by Mr Farmer, such as

where an individual's decision to purchase a rental property is influenced by the availability of an income stream against which interest payments on borrowing may be deducted. In this case the availability of tax shelter was inextricably linked to decisions on whether to implement transactions. The extent to which one drove or influenced the other is a question of fact and degree.

Arrangement

[569] Westpac pleads that:

> The core element of the Koch transaction was an investment by TBNZI in preference shares in a United States incorporated company from which TBNZI received dividend income. Other related elements included an agreement by TBNZI to sell those shares to a member of the Koch group of companies at a later date, a currency and interest rate swap between WBC and that same member of the Koch group of companies, a guarantee by another member of the Koch group of companies in respect of which TBNZI paid a procurement fee, and an internal interest rate swap between WBC and TBNZI. Further details of the Koch transaction are set out in Appendix 1.

[570] The Commissioner accepts that that summary as detailed in the individual steps (set out at [121]-[146] above) constitutes the relevant arrangement for each transaction for the purposes of s BG 1. He pleads, and Westpac accepts, that it extended to all discussions, negotiations, decisions and correspondence, both internal to the Westpac group and with the respective counterparty, as to the transaction structure (including characteristics of the entities to be employed) and the implementation steps. The bank also accepts that the arrangement was priced by the use of a formula involving, among other things, the sharing of tax benefits (but disputes the nature and extent of what was shared).

[571] However, Westpac denies that the arrangement extended to include any external funding raised for the purposes of financing a transaction. The Commissioner contends that the bank raised funds from the market for the specific purpose of financing these transactions; and that this act logically constituted a step by which the transactions were carried into effect, making it part of the impugned arrangement. Westpac's counter is that such funding is a function of its overall

group funding arrangements; as such it is not part of the arrangement with the counterparty.

[572] In my judgment the Commissioner was correct in determining that the arrangement included borrowing undertaken to provide funds. The definition of an 'arrangement' is not restricted to the four corners of the legal contract or agreement between the bank and the counterparty. It includes that instrument but expressly extends to include 'all steps' by which it is carried into effect.

[573] Westpac's initiating step was to source or locate sufficient funds to meet its contractual obligation to Koch. There is a plethora of internal correspondence dealing with the arrangements to borrow on the international money markets for this purpose. Without or but for that step, the transaction would never have gone ahead. The bank's borrowing was 'an indispensable part of that which produced the tax benefit': *FCT v Hart* (2004) 217 CLR 216, 225 per Gleeson CJ and McHugh J. And, I repeat again, its cost of finds fixed at the current swap rate was an integral component of the dividend rate formula through which its taxation benefits were shared.

[574] Westpac's funding arrangements were, I find, part of the statutory arrangement with each counterparty.

Conclusion

(1) Approach

[575] The concluding step is to determine whether Westpac has discharged its onus of proving that the transactions were not tax avoidance arrangements. The ultimate question, to be answered by an objective analysis of the evidence relating to all relevant steps forming part of the arrangement, is: was tax avoidance the purpose or effect of the arrangement and, if there was more than one purpose or effect, was tax avoidance a not merely incidental purpose or effect?

[576] The length of this judgment speaks for itself on the extent to which evidence and argument was directed towards reconstructing facts that fell relevantly within a relatively narrow and unambiguous compass. It is thus appropriate to repeat that the avoidance inquiry is strictly circumscribed. Its focus is on the arrangement. An objective examination of the documents is required, directed towards the transaction's effect. The purpose is then to be deduced or inferred from the arrangement itself and its effect.

(2) Tangential Factors

[577] Before undertaking the avoidance inquiry, I shall refer briefly to some tangential aspects of the Commissioner's case simply to dispose of them. It was suggested that adverse inferences should be drawn within the tax avoidance inquiry from a number of factors. There was reference to the advantages obtained by 'foreign owned banks' which were unavailable to other corporates in deploying the conduit and foreign tax credit regimes and to Westpac's failure to publicise the transactions. Evidence was led from Professor Evans about the economic implications and social cost of the transactions for New Zealand society. Also, the word 'formulaic' was frequently used (there is nothing inherently objectionable in using a standard formula to calculate a dividend rate; the issue in this case related to the constant inclusion of the GPF at the same or a similar figure). None of these factors assists in determining whether a taxpayer's use of deductibility provisions in a particular transaction is evidence of tax avoidance.

[578] A good deal of argument and evidence was directed towards the swap concept. Unlike *BNZ Investments (No 2)*, however, there was nothing to suggest that Westpac acted uncommercially either in swapping currencies immediately after the transaction was entered into or in using the five year swap rate as the benchmark for the opportunity cost component of the dividend rate.

[579] Mr Croft's comprehensive evidence that the swaps were commercial and transacted at prevalent market rates, and in accordance with market standards and practice, was not disputed. Westpac and the counterparty had a proper commercial rationale for converting their principal costs and exposures to their preferred

currency with consequential interest liabilities. Neither party could have forecast the amount of a loss on the swap rate, given the inherent dynamics of currency movements. (Mr Gibbs' 18 May 1998 SFC paper shows, however, that he was working on the assumption that swap losses would be incurred.)

[580] Nor do I accept that there was significant circularity of the type suggested by some of the Commissioner's witnesses. Circularity is a catchphrase frequently cited but infrequently enlightening. Circularity in this context is normally understood to refer to movements of money which conceal the fact that there was no underlying activity at all: *Peterson* per Lord Millett at [45]. But here each payment discharged a genuine contractual liability. And the existence of exchanges of funds of similar amounts to meet quarterly interest obligations does not connote circularity, given that there was a proper commercial basis for the underlying currency swaps.

[581] Novelty, while sometimes associated with avoidance, is not relevant. Nor is the fact that these transactions differed in some way or ways from conventional share repurchase financing transactions. Their characterisation as structured finance transactions is one of convenience, not of legal definition. Comparisons with similar transactions undertaken by other institutions are inconclusive.

[582] Once these distractions are placed to one side, the necessary focus can be brought to identifying the feature or features of the transactions relevant to an inquiry into whether they were arrangements entered into for the purpose or having the effect of tax avoidance.

(3) Effect

[583] What then was the effect of Koch? In essence, Westpac advanced NZD390m to a foreign counterparty, KCS, for a term of five years but repayable earlier on notice. Its parent, KII, guaranteed repayment. Koch's cost of funds was 7.7177% per annum, expressed as the distribution or dividend rate payable quarterly on Kiwi's preference shares. The other cost was the bank's payment to Koch of a GPF of 2.85%, also payable quarterly. These were the two principal money flows. To quote

Professor Hodder, the transaction was, for all its outward complexity, 'very simple at its core' (see [19] above).

[584] The pricing structure was straightforward. The parties fixed the dividend rate by adding two constant elements (omitting minor items for spreads, fees and TLPs), reduced by 50% of the New Zealand corporate tax rate. One element was Westpac's swap rate or marginal cost of funds. The second was an amount equal to the GPF.

[585] The GPF component of the dividend rate introduced an economic distortion. It raised the price of Koch's funds to a level significantly in excess of market for a highly rated entity. The then current LIBOR debt rate for an AAA rated entity (Koch was AA+) was only 6.40%; the dividend rate on Koch was 7.7177%. On the other side of the ledger, Westpac was lending to a higher rated entity at a price correspondingly in excess of its own cost of funds, then calculated at 6.955%, while contemporaneously returning to Koch an amount equal to 37% of its income stream.

[586] Viewed objectively, the transaction did not make commercial sense. The documents fail to justify Koch's agreement to pay a GPF component within the price of funds which were well above LIBOR. They fail to justify Westpac's ability to lend to a higher rated entity at such a margin. And they fail to justify each party's agreement to exchange equivalent amounts. Expert reconstruction can never fill the evidential void or explain away the inexplicable.

[587] Nevertheless, despite this unpromising appearance, both parties enjoyed extraordinary financial benefits after tax (see Professors Evans, Saunders and Hodder and Dr Fitzgerald above at [530]-[545]). Westpac's projected pre-tax loss on Koch of -1.9473% was converted into an after-tax profit of 1.24215%. Koch's profit of 1.2251% was similar, achieved from a negative borrowing rate.

[588] Both returns were well above market. And the results ran directly counter to orthodox market theory that it was not generally possible for a lower rated entity to lend to a higher rated one and earn any, let alone an extraordinary, return on capital. Such were the attractions that by August 2002 18% of Westpac's assets or

NZD4.36b were invested in these transactions (at [1] above), despite their pre-tax unprofitability.

(4) Purpose

(a) Commercial Purpose

[589] Mr Brown argues that the arrangements had no commercial purpose because there was no underlying commercial transaction. He says each relied on favourable tax treatment for its very existence – that is, it was not simply a preferred or selected tax enhanced form of an already envisaged commercial transaction. In truth, Mr Brown says, the tax advantages came first and the transaction followed. He accepts, however, that the arrangements might be seen as economically rational because the post-tax benefits for both parties were 'extremely significant'.

[590] I agree with Mr Farmer that each transaction had a genuine commercial purpose. In my judgment the structural aspects, and in particular its taxation benefits, do not derogate from the existence of an objectively ascertainable commercial purpose. That purpose must be distinguished from the transaction's underlying commerciality or business viability. They are conceptually separate.

[591] Westpac advanced substantial amounts of money to overseas counterparties subject to an obligation to repay. The funding was linear, not circular, and the credit risk shifted from the bank to the economic borrower. Whether or not Westpac knew the particular use to which the other party intended to apply the funds is irrelevant.

[592] As Mr Farmer says, the counterparties might have allocated the money for general working capital purposes or to retire more expensive funding. That was not Westpac's business or concern. The treasuries of large institutions manage portfolios of funding sources for use as and when required. It does not matter that there was no specific purpose in mind when the funds were raised.

(b) Tax Avoidance: GPF

[593] The question then is: did the transactions have a separate purpose of tax avoidance which was not merely incidental or subsidiary to the commercial purpose? The GPF is, as Mr Farmer appreciates, the obvious focus. Its payment was an essential step in and by which each transaction was carried into effect. Its amount was also an essential component of the formula used to price the shares.

[594] I have found that Westpac unlawfully claimed deductions for the GPF and that the Commissioner is entitled to disallow them. That finding is discrete, however, from the wider avoidance inquiry. What is germane is my independent finding that the GPF itself did not serve an objectively ascertainable business purpose. The amount was substantial but was never the subject of careful evaluation or negotiation. The orthodox element of commercial tension was notably absent. But even if the GPF was of itself justifiable, its amount substantially exceeded a notional market rate.

[595] Why then did Westpac agree without question to pay the GPF? I am in no doubt that the GPF's function was to generate a statutory deduction for an expense which appeared genuine but was in truth a contrivance: *Ben Nevis* at [122]. Its existence is a 'classic indicator' of a tax avoidance purpose: *Ben Nevis* at [108]. Westpac claimed a deduction for the GPF on the misleading representation, which it must have expected the Commissioner to accept in good faith, that the expense was commercially justifiable and fixed at a market rate.

[596] Specific deductibility provisions are to be invoked where the taxpayer has by the transaction incurred 'real economic consequences of the type contemplated by the legislature when the rules were enacted'; and where the taxpayer is 'engag[ing] in business activities for the purpose of making a profit': *Accent* at [126]. The dividend formula explains why Westpac claimed a deduction for an expense which did not incur real economic consequences of the type envisaged by the deductibility provisions. The financial returns enjoyed by both parties were the result of a

formula designed to share deductions derived by Westpac where in substance the economic burden and benefit were non-existent.

[597] As Mr Brown submits, all the evidence points to a unity of purpose in obtaining and dividing the maximum possible tax benefits available to Westpac. This purpose was successfully achieved by means of a contrivance, both in concept and amount. The contrived expense was also, by virtue of the self-cancelling effect of the exchanges inherent in the pricing structure, illusory. The disparity between the underlying economics of the transaction and the resulting taxation treatment confirms that the anticipated tax effect was the true purpose of the transaction.

[598] Westpac's constant, indeed predominant, expectation that Koch would yield a loss is consistent with this conclusion. The prospect of generating substantial deductible expenses and altering the incidence of its income tax was, I am satisfied, the bank's primary purpose in proceeding with Koch.

[599] In distinguishing *Ben Nevis*, Mr Farmer referred to the majority's conclusion that the forestry investment was a tax avoidance arrangement because 'there was no real business purpose as there was a real risk that the transaction would not be profitable'. Similarly, in my judgment, there was according to Westpac's contemporaneous documents no underlying prospect of profitability and thus no commercial justification for the Koch transaction.

[600] When the contrivance of the GPF with its surrounding documentary complexity is removed from the equation, the remaining element of the dividend, described as Westpac's marginal cost, equalled its own cost of funds. The two imposts effectively cancelled each other out. There never could be a true profit margin.

(c) Legal Structure

[601] The GPF's artificiality is highlighted by its structural context. The consistent theme of Westpac's case, apart from Mr Green's argument on deductibility, was one of reinforcement of the juristic nature of the transaction. However, the bank's

conduct, or more particularly its omissions, were diametrically inconsistent with that structure. Westpac was willing to pay the GPF without considering the availability of alternative security, without evaluating the assets being purchased (its 'primary investment'), and without undertaking a credit analysis of the borrower. The fee was not the subject of negotiation. And its amount was significantly in excess of any possible notional market value. In short, the GPF was a gratuitous mechanism: *Ben Nevis* at [119].

[602] The parties always contemplated that Westpac would loan or advance funds to the Koch group. There was no rational purpose, as Ms Ellis submits, in later introducing an existing subsidiary, KCS, as the legal borrower. That corporate structure was simply an adaptation of convenience, further distorting the economic reality. The parties' treatment of KCS, rather than KII, as the legal borrower was designed to rationalise the GPF concept; payment of a fee to the parent for providing its own guarantee would have raised obvious legal and commercial problems.

[603] The bank's payment of a gratuitous (and substantial) fee, and its unexplained indifference to critical elements of the transaction, establishes the artificiality of the legal structure which it superimposed and its consequential rights and obligations. This was not a case of a taxpayer choosing the most advantageous structure of a transaction for tax purposes; I am satisfied it was a case of a taxpayer selecting a form which was contrary to and designed to re-characterise the transaction's economic substance as a loan for the purpose of avoiding liabilities to tax.

[604] Taxpayers are free to structure their affairs in the most tax effective way, and to take the post-tax consequences into account when deciding whether to proceed with a transaction. But that right is exercised on the assumption that the transaction has an independently justifiable commercial rationale. In this case the 'clarity of the tax advantages was in marked contrast to the obscurity of the prospect of any ultimate commercial profit': *Ben Nevis* at [122]. The profits that accrued to both parties were, I find, essentially a product of Westpac's impermissible use of the specific provisions.

(d) Specific Provisions

[605] Koch's primary purpose was, I think, to directly reduce Westpac's liability to pay income tax by misusing the specific provisions. The bank did not actually expend the GPF or any part of it in deriving its income. The expense was never in economic reality incurred.

[606] Self-evidently, such a deployment would not have been within Parliament's contemplation when the ITA was enacted. The legislature would not have contemplated that a taxpayer might lawfully use the deductibility provisions, in conjunction with a pre-existing right to exempt income, to provide funding to a party at a price considerably below market by returning a share of the domestic taxation benefit derived from claiming a deduction for a non-existent expense.

[607] Mr Brown submits also that Westpac obtained exempt income under the specific conduit provisions for Koch, Rabo 1 and Rabo 2 in circumstances where it knew that it would never pay the economic price intended by Parliament to be paid for that exemption – that is, the 15% NRWT intended to be payable when the dividends were repatriated to Australia. He submits that the conduit regime was not intended to disturb one of the fundamental precepts underlying the ITA; that is, that non-resident taxpayers would pay tax on their New Zealand sourced income.

[608] Westpac subverted that aim, Mr Brown submits, by entering into arrangements that used the regime and the specific provisions to avoid paying tax on New Zealand sourced income. The conduit regime was intended to neutralise existing disadvantages to foreign owned companies investing through New Zealand. Mr Brown says Westpac contrived to use the regime in order to give it a positive advantage over other companies liable for tax in New Zealand.

[609] In *BNZ Investments (No 2)* Wild J considered this issue in detail. He was satisfied that the conduit regime was introduced to remedy the anti-competitive nature of a New Zealand market where non-residents are taxed on foreign sourced income (where other countries allowed non-resident investors to make global

investments without paying tax to intermediate countries). Wild J concluded that the legislative policy was that some at least of the conduit relieved income would be passed on as dividends by the New Zealand subsidiary to its foreign owner, thereby attracting 15% NRWT (at [243]).

[610] It is unnecessary for me to repeat a discussion of similar arguments advanced in this case. I respectfully endorse Wild J's analysis in *BNZ Investments (No 2)*, except that I do not construe the specific provisions as requiring dividends subject to conduit relief to be passed through New Zealand to a foreign parent.

[611] The fact that conduit relief enabled a taxpayer to obtain dividends which accrued credits is not problematic in itself. It is the fact that the transactions were loss making, and thus never resulted in dividends being paid to non-resident shareholders, which is an objectionable consequence of the transaction as a whole. In my judgment it would not have been within Parliament's intention to allow a taxpayer to structure a transaction in such a way that NRWT would never be paid.

[612] The CSFB transaction similarly circumvented the policy behind the foreign tax credit regime. As demonstrated by s LC 1(3A), the FTC regime was intended to provide New Zealand taxpayers with credits for tax paid in a foreign jurisdiction. Yet the economic burden of the US tax on the gross distribution was not in fact paid or economically suffered by either Westpac or the counterparty. As Coopers & Lybrand wrote to Westpac on 25 June 1998:

> … the US counter party enjoys what is effectively a double deduction in the United States (for the interest paid, and second in relation to the partnership distribution), in substance the tax in relation to which a credit is claimed in New Zealand is not real. In practical terms, it is refunded.

I accept, as Wild J did, the Commissioner's argument that the actual payment of foreign tax is the policy foundation of the FTC regime and that, without such a payment, there is nothing against which to allow a credit. The CSFB transaction was, in economic substance, incompatible with the FTC regime.

(e) Tax Shelter

[613] Other factors reinforce the conclusion of avoidance. Messrs Gibbs and Mataira admitted the primary purpose of transactions undertaken by the structured finance unit was to minimise tax – that is, to reduce, and thus avoid, taxation otherwise payable on income earned by the bank. For this reason, Westpac's tax shelter or capacity in any given year dictated whether a transaction would proceed.

[614] The availability of tax shelter, and the fiscal consequences of its use, was a central feature, if not the central feature, of Mr Gibbs' 18 May 1998 SFC memorandum. The SFC did not give approval unless Mr Mataira was satisfied that the bank would earn sufficient income in the foreseeable future to shelter the forecast deductions. The purpose of avoiding tax by obtaining deductions against income was a dominant, if not the predominant, element in the decision to proceed with each transaction.

[615] The nature, scale and intensity of Westpac's use of tax shelter was far removed from Mr Farmer's example of a decision by an individual taxpayer to purchase a residential property provided he earned sufficient income to absorb borrowing costs. In that instance the investor will have reached a conclusion based on the standalone commercial viability of the acquisition. The taxation consequence will be a relevant but subsidiary factor. If the position was otherwise – and the taxation advantages dictated the decision to buy – the investor would be at risk under s BG 1.

[616] And I am unable to accept Mr Farmer's analogy between this transaction and the type of justifiable concurrent purposes identified by Woodhouse P in *Challenge* at 533-534. The President was exempting from the section's reach the activities of the conventional exporter who did not 'trade to save tax but to achieve profits', where tax was one of a number of costs taken into account. In Woodhouse P's example it must have been within Parliament's contemplation that an exporter's commercial decision would be significantly influenced, even driven, by the availability of a taxation incentive which would be unavailable for a domestic sale.

The legislature would envisage use of the incentive to promote an activity of general economic benefit.

[617] However, there is nothing to suggest that Parliament contemplated a bank's contrived use of the specific provisions as being of general economic benefit. It was not a case of a taxpayer making an election between two means of carrying out an economically rational transaction, one of which would result in less tax being payable than the other: compare *Europa* at 556. Westpac never viewed these transactions through the lens of inherent profitability, independent of taxation benefits. To adapt Woodhouse P's phrase, Westpac loaned funds to save taxes, not to achieve profits. I agree with Mr Brown that, for the bank, the tax advantages came first and the transaction followed.

[618] The tax avoidance purpose here could never be regarded 'as a natural concomitant' of a dominant commercial purpose. Deployment of the deductibility provisions to reduce the bank's liability to income forecast in the following year in accordance with its tax shelter or capacity calculation became a discrete and real end or objective on its own. I find that Westpac's use of its tax shelter was a significant or actuating purpose which was pursued as a goal in itself in each transaction. As a matter of fact and degree, Westpac's tax avoidance purpose was more than merely incidental to any legitimate commercial purpose.

(f) Summary

[619] This case could not possibly fall into that rare category which might result in a conclusion that the tax avoidance purpose was merely incidental despite the taxpayer's misuse of the specific provisions: *Ben Nevis* at [114]. In my judgment Koch and the other three transactions were tax avoidance arrangements. Their primary or a substantial purpose was to reduce the incidence of the bank's liability to tax.

[620] I appreciate that I have reached the same conclusion on avoidance as Wild J in *BNZ Investments (No 2)*. The interposition of the GPF has proved decisive on the

facts of both cases. However, as I trust will be apparent, my decision is the result of an independent analysis of the evidence presented in this case.

Reconstruction

(1) Legal Principles

[621] The Commissioner has adjusted the amounts of assessable income payable by Westpac, its deductions claimed and the available net income to counteract any 'tax advantage' obtained by the bank from a void 'tax avoidance arrangement'. He is entitled to counteract the tax advantage gained under an avoided arrangement on this basis: s GB 1:

> (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 ad 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.

[622] Two major principles emerge from s GB 1. First, once the Commissioner avoids an arrangement he 'may' adjust the amounts of gross income, allowable deductions and available net losses including calculating taxable income 'in the manner [he] thinks appropriate'. The traditional principles of judicial restraint in determining a challenge to a discretionary power apply; the question is whether the Commissioner 'adopted a reconstruction which was outside the scope of his powers': *Ben Nevis* at [170].

[623] Second, the adjustment is directed 'to counteract any tax advantage obtained' by the taxpayer. The Commissioner is entitled to have regard to such amounts of gross income, allowable deductions and available net losses as in his 'opinion' the taxpayer would have or could be expected or likely to have made but for the arrangement. In this respect I agree with Mr Brown that the Commissioner is not required to postulate an alternative beneficial transaction into which the taxpayer might have entered but did not do so: see *Accent* at [155]:

> The effect of ss BB 9 and GB 1 is that the scheme is void as against the Commissioner. Under that void scheme, the taxpayers claimed deductions to which they were not entitled. The entirety of the deductions was thus illegitimate and their extent provides the measure of the tax advantages which the Commissioner must counteract. The counter-factual envisaged by the s GB 1(a) is the position "if that arrangement had not been made or entered into". There is thus no need for the Commissioner (or Court) to conjure up an alternative and more effective scheme into which the taxpayers might have entered.

[624] The Commissioner has elected to counteract Westpac's tax advantage by disallowing all deductions relating to a transaction – that is, the cost of funds, the swap losses and the GPF. He has not followed the alternative route of impugning the bank's income (he may have had valid grounds for disallowing an exemption at least for that amount of Westpac's income attributable to the GPF equivalent of the dividend rate). In this respect the Commissioner's duty: *O'Neil v Commissioner of Inland Revenue* [2001] 3 NZLR 316 at [22]:

> … 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.

[625] On a challenge to the Commissioner's reconstruction the Court's powers are to confirm, cancel or vary it. Section 138P Tax Administration Act 1994 provides:

> (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.
>
> …
>
> The time bars in sections 108, 108A, and 108B do not apply with respect to—
>
> (a) A determination of a hearing authority made under subsection (1)(a) or subsection (1B) of this section or an amendment made by the Commissioner to an assessment for the purpose of conforming to such a determination; or
>
> (b) An assessment made by a hearing authority under subsection (1)(b) of this section or the Commissioner under subsection (3) of this section.

[626] Mr Brown emphasises two aspects of s 138P. First, on review this Court's power is limited to making an assessment that 'the Commissioner was able to make at the time the Commissioner made the assessment to which the challenge relates'. What is decisive is the state of the Commissioner's knowledge when the reassessments were made, based on exchanges of statutory notices. The original assessments were made in 2004 and 2005. Facts arising subsequently are irrelevant.

[627] In support of a contrary submission Mr Green relies on this passage from *Commissioner of Inland Revenue v Canterbury Frozen Meat Co Ltd* [1994] 2 NZLR 681 per McKay J at 692-693:

> The Commissioner is to determine as best he can on the information available what is the amount on which tax is payable and what is the amount of the tax. If he makes a mistake or otherwise reaches a wrong conclusion, that can only be challenged and put right through the objection procedure.

[628] I do not read McKay J's statement as contradicting Mr Brown's submission. With respect, the Judge was stating the obvious of the taxpayer's right to rectify a mistake through the objection procedure. He was discussing that right in the context of the reviewability of the Commissioner's assessment. Moreover, McKay J's

observations were made about an analogous but differently worded provision of the Income Tax Act 1976.

[629] The express words of s 138P validate Mr Brown's submission. The criterion is the Commissioner's ability to make the assessment at the time it was made. Mr Green says the Commissioner should reasonably have known, before issuing the assessments, what constituted, for example, the funding costs claimed by the taxpayer. He says the Commissioner could have performed the calculations carried out by Professor van Zijl by reference to Westpac's returns.

[630] The issue is of an essentially factual nature. Unless Westpac had put the Commissioner on express notice prior to issuing the reassessments of its assertion that its funding costs were its actual average deductible cost of funds, his failure to undertake the same exercise of his own volition could never be criticised as unreasonable. I am not satisfied that the Commissioner was reasonably able to undertake a task which Mr MacDonald said was beyond the bank's own resources.

[631] Second, the taxpayer bears the burden of proving on the balance of probabilities that 'the amount of an assessment is excessive by a specific amount'. This burden is both strict and critical: see *Ben Nevis* at [171]:

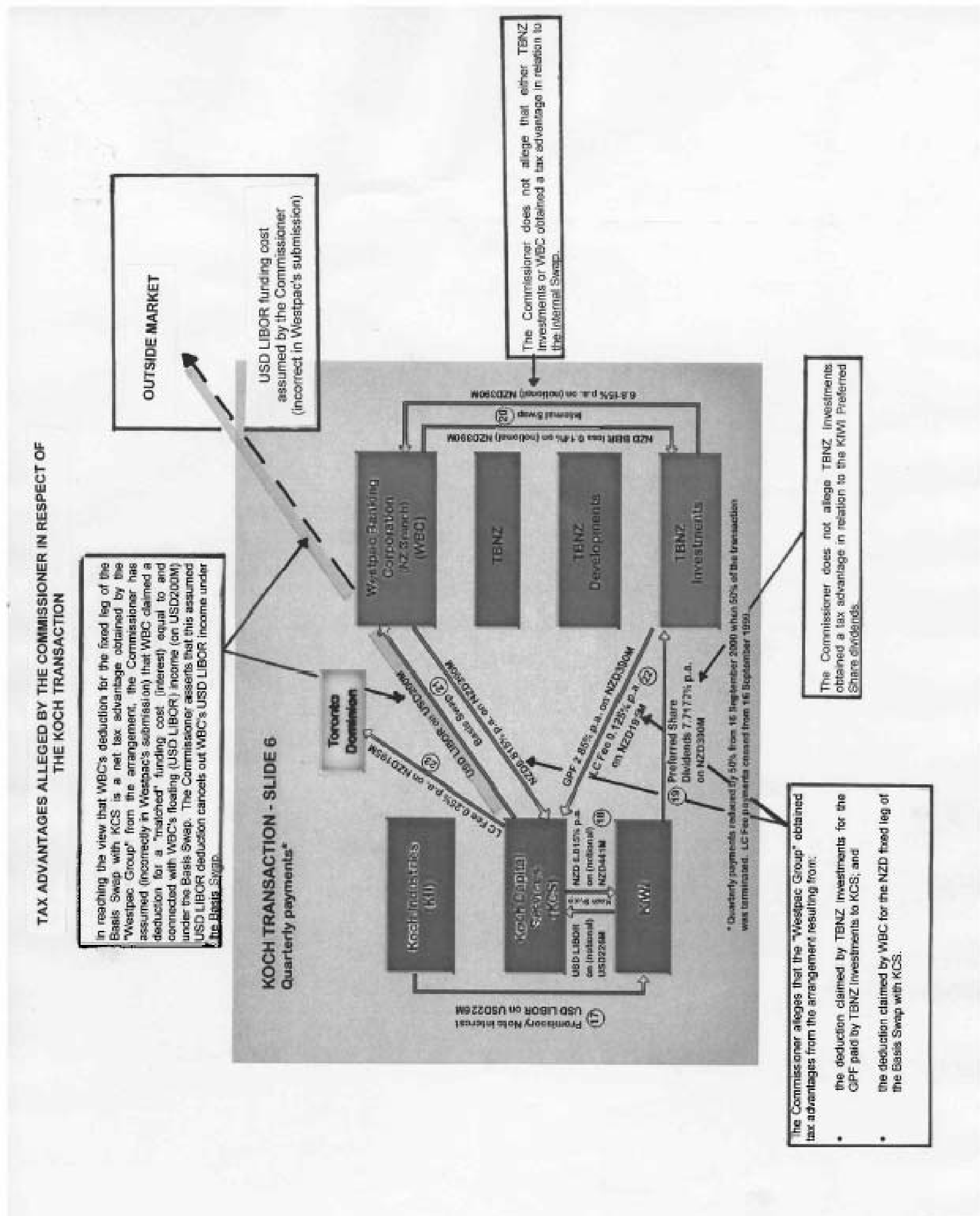
> Furthermore, when taxpayers challenge an assessment based on a reconstruction adopted by the Commissioner, the onus is on them to demonstrate, not only that the reconstruction was wrong, but also by how much it was wrong. Unless the taxpayer can demonstrate with reasonable clarity what the correct reconstruction ought to be, the Commissioner's assessment based on his reconstruction must stand. This is settled law. In this case we are of the view that the appellants have not shown that the Commissioner's assessment based on his reconstruction was wrong. Even if they had shown that to be so, they have not shown on any reasonably clear basis to what extent it should be varied. The appellants did not submit any specific proposed reconstruction of their own, the validity of which the Court could then have evaluated. The Commissioner's assessment must therefore stand.
>
> [Citations omitted]

[632] Mr Green does not take issue with Mr Brown's second proposition.

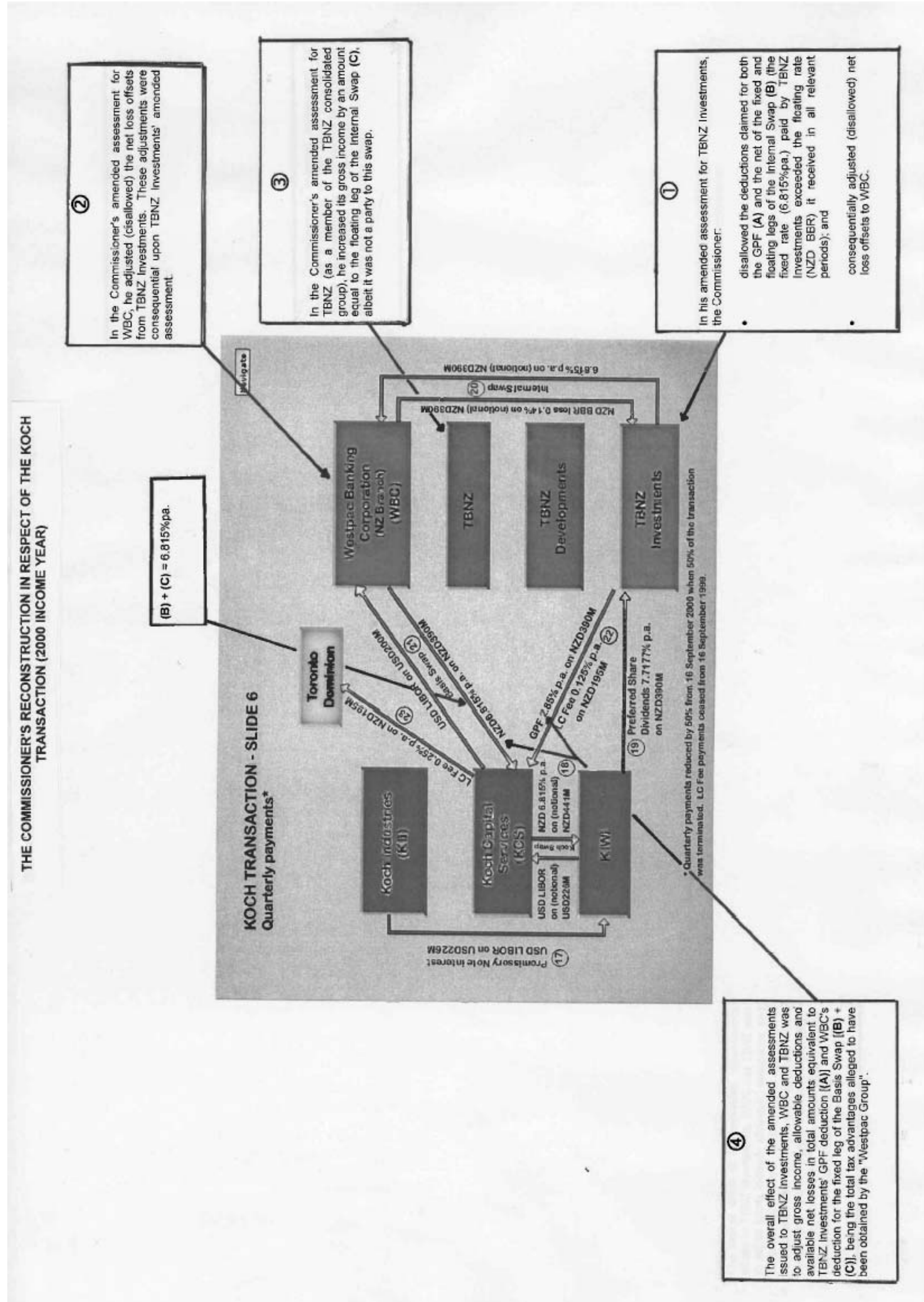
(2) Commissioner's Reconstruction

[633] The Commissioner asserts that over the seven relevant years Westpac avoided paying $586m of tax on its profits from other New Zealand activities. Accordingly, in each of the two income tax years which are the subject of these representative proceedings, the Commissioner has adjusted deductions claimed for GPFs (both under specific provisions and s BG 1) and net expenditure on swaps and interest incurred in funding the arrangements (the main area of dispute). He has also counteracted reductions in gross income returned due to the withdrawal of deposits to fund some arrangements, in net income claimed for subvention payments relating to net losses resulting from the arrangements, and net income for transferred net losses arising from expenditure incurred under the arrangements. The adjustments for the last two items have been made alternatively pursuant to subpart IG.

[634] The tax advantages alleged by the Commissioner on Koch are shown as follows:



[635] The Commissioner has reconstructed Westpac's liability on Koch for 2000 as follows:



(3) Westpac's Challenges

[636] Westpac maintains three substantial challenges to the Commissioner's reconstruction. The bank contends that he has (1) failed to properly identify the tax advantages accruing to the bank; (2) incorrectly disallowed its deductions for the cost of funds; and (3) failed to limit reconstruction to the extent to which the GPFs are found to exceed an arm's length range of value. I shall address each ground in the same sequence.

(a) Tax Advantage

[637] The Commissioner says that Westpac obtained a dual advantage from and under a void arrangement, being receipt of exempt income and deductions incurred in deriving it. That, the Commissioner says, is the product of the arrangement as a whole. He contends that Westpac's funding formed part of the 'tax avoidance arrangement', being a critical 'step … by which [the transaction] was carried into effect' (s OB 1), even though it did not form a term or condition of the transaction itself. Westpac takes a narrower view, saying that, because the funding was not part of the strict contractual set-up with the counterparty, it was not a 'step' by which the transaction was carried into effect. I have determined that dispute in the Commissioner's favour.

[638] Mr Green submits, however, that the Commissioner is 'required to determine precisely what constitutes tax avoidance' and 'the particular aspect of an arrangement that gives rise to a tax advantage'; and that he is obliged to focus on those elements of the transactions which according to his views are offensive. Mr Green points to *Ben Nevis* where only the licence premium and insurance arrangements were affected, not the third party expenditure. He challenges the Commissioner's selection of the swap rate used in the transactions for Westpac's funding costs, enabling removal of the floating leg of the swap undertaken with a third party. He says the funding costs and the GPF are separate and stand alone. Each must be segregated off and considered by itself.

[639] I do not accept Mr Green's submission as a matter of principle for a number of reasons. First, the Commissioner's statutory obligation to reconstruct is simply to counteract a tax advantage obtained from and under a transaction. He is not under any further duty to determine precisely what constitutes the tax avoidance or identify a particular aspect giving rise to a tax advantage. To the extent that he may be under such an obligation, the Commissioner's reassessment manifests his satisfaction that the tax advantages he counteracts are the same as those identified by Mr Mataira – the deductions for funding costs including swap losses and the GPF.

[640] Second, a tax avoidance arrangement is void as against the Commissioner for income tax purposes; it does not call into question the integrity or otherwise of contractual relations between the taxpayer and third parties. The arrangement is the transaction itself together with all steps by which it is carried into effect. The Commissioner concluded that Westpac's arrangements to fund the transaction by borrowing on the international markets was a critical step. Without it, Westpac would not have had the financial resources to fund a particular transaction.

[641] Third, the Commissioner is not bound to isolate out and counteract only particular elements giving rise to a tax advantage. Westpac's tax advantage combined two principal elements of deductibility falling within the composite label of the cost of funds – funding costs and the GPF. There was no hierarchy or ranking between them. While only the GPF was unlawfully deducted and the separate source of a finding of avoidance, none of the deductions would have been generated without completion of the transaction as a whole. All its elements were integral. The bank was able to set-off or deduct all expenses against its other New Zealand income as a result.

(b) Cost of Funds

[642] Mr Green says, nevertheless, that, of the two principal elements, the Commissioner was wrong to disallow Westpac's deductions for funding costs. He says they were incurred in meeting genuine obligations to third parties unrelated to the transactions. The costs were expended at arm's length in the ordinary course of the bank's business. They were not shared with the counterparties. They did not

feature anywhere in the transactions. Any deduction claimed for that interest, Mr Green says, is not a benefit 'from and under the arrangement'. It is no more than the result of borrowing in the market and incurring an expense which is deductible in the ordinary course of a banking business.

[643] Mr Green submits that:

> As both sides of all the bank's funding arrangements were at arm's length with unrelated parties, it would have been inappropriate to attack those arrangements – it is not just the quantum of the interest paid by WBC or the characterisation of the receipt from the counterparty which have been attacked, but the arm's length third party funding itself. If the underlying transactions are attacked rather than the characterisation of receipts or the quantum of outgoings, that results in very real transaction steps being void which clearly do exist between unrelated parties. It is a very unusual result for ongoing contractual relations between unrelated parties, which impose real obligations and have commercial consequences, not to exist for the purposes of the application of the income tax legislation.

[644] Mr Green reverts to the authority of *BNZ Investments (No 1)*, and Richardson J's statement at [56] that:

> … a standard commercial RPS investment which in terms of the Income Tax Act entitled BNZ to a deduction for interest on the sums borrowed for investment in the RPS and provided that the dividends on the RPS would be exempt income as inter-company dividends. The RPS investments are a far cry from the self cancelling and circular schemes that have come before the New Zealand and Australian Courts under the general anti-avoidance provisions.

[645] I agree with Mr Green. The asymmetry described by Richardson J is also present as an element of these transactions. Westpac claims both the right to exempt income on the preference shares and deductions for borrowing costs to acquire them. But that is not the point. In *BNZ Investments (No 1)* the Court of Appeal was not required to determine reconstruction given its conclusion that the bank was not a party to a tax avoidance arrangement. Here, I have found that Koch, for example, was a tax avoidance arrangement, entered into with tax avoidance as one of its purposes or effects and that it extended to steps taken by the bank to raise funding for the transaction.

[646] On that basis, the deduction claimed by Westpac for the costs of borrowing the funds was a benefit 'from and under the arrangement'. It is irrelevant that the

benefit was the result of borrowing in the market and incurring an expense which is deductible in the ordinary course of a banking business. Contrary to Mr Green's submission, the Commissioner does not call into question or impugn the integrity of Westpac's underlying contractual obligations with third parties. His power is limited simply to avoiding a taxation consequence or advantage claimed by one of the parties as against *him*. He has not sought to exercise it more widely.

[647] Alternatively, Mr Green submits, the amount of the funding cost disallowed by the Commissioner is excessive. Assuming a tax advantage was obtained, by definition, he says, it must relate to the actual deductions claimed. On this basis the Commissioner had no justification for treating the fixed swap rate as the hypothetical proxy for Westpac's funding cost. On Professor Van Zijl's calculation, the bank's tax advantage is limited to a figure calculated according to its average deductible cost of funds.

[648] I reject this submission for reasons already given; I am satisfied that the bank's actual cost of funds for these transactions was the swap rate. In any event:

(1) This Court's power is limited to reviewing the state of the Commissioner's knowledge when the reassessments were issued following exchanges of statutory notices. Westpac did not then assert, and the Commissioner was unaware, that the bank's funding costs were its average deductible cost of funds;

(2) Westpac has not attempted to discharge its burden of proving the specific amount by which the assessment is excessive.

(c) GPF

[649] Finally, Mr Green focuses on the GPF. While he has not described it as such, I am treating his argument as separate from his earlier proposition, which I have rejected, that the Commissioner was bound to segregate out the two elements of Westpac's tax advantage. The fact that I am able to address it with relative brevity is not a sign of disrespect for the quality of the argument. That is because the issue is

discrete and can be concisely stated, and I have already made findings on the GPFs' status and use. The fiscal consequences are, however, substantial.

[650] Mr Green relies on both *Europa* cases (*Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1974] 2 NZLR 737 (CA), per Richmond J at 740 and Beattie J at 742; *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546 (CA) at 570) and *CIT Financial Ltd v The Queen* (2003) TCC 544 at [70]. He submits that a taxpayer is always entitled to deduct as being necessarily incurred in the carrying on of its business the arm's length market or benchmark price of an item, if the cost of such an item is otherwise deductible.

[651] Here the GPF was, Mr Green submits, within an arm's length or market range. But, if the fee was excessive, Westpac is entitled to deduct that part which is found to be at market. He says that in the latter event there is sufficient evidence before the Court to enable a determination of an appropriate adjustment. He identifies Mr Seve's reference to valuing an intra-company guarantee at up to 1% or 100 basis points.

[652] In this respect I have already made two relevant findings. One finding is that the GPF was not lawfully deductible. However, I must consider Mr Green's argument against the contingency either that that conclusion is in error or that the claim for the GPF should be discretely disallowed in entirety, leaving the other deductions intact. The other finding is that the GPF was not fixed at a market or commercial rate in any event.

[653] Mr Green's argument relies on the factual premise that the transactions would have been independently profitable and attractive to both Westpac and the counterparty even without the GPF; that is, if no fee was paid and what he calls the notional credit margin in the dividend formula was reduced to zero. Thus the dividend rate on Koch would have been reduced from 7.7177% to 5.44%. Grossed up to calculate its pre-tax equivalent, the rate would have been 8.12%. The benchmark swap rate of 6.815% and the letter of credit fee of 0.0625% (8.12% - 6.815% - 0.0625%) would be reduced from that figure. Westpac's equivalent

margin would thus have been 1.24%, compared with the actual transaction figure of 1.79%.

[654] On the same basis Koch's benefit – the funding cost saving below LIBOR – would have been reduced from 1.67% to 1.10%. That would occur by reducing the benchmark swap rate (6.815%) by the dividend rate (5.44%), KCS's contribution to the letter of credit fee (0.0625%) and the Babcock fees paid by Koch (0.21%) (6.815% - 5.44% - 0.0625% - 0.21%), resulting in an amount of 1.10%.

[655] This example, Mr Green submits, represents the transaction that the parties 'could in all commercial likelihood have entered into' without the GPF. He refers to the early transaction proposals preceding Koch which omitted the GPF or a guarantee fee. In essence his argument is that the only tax advantage obtained by Westpac 'from or under [the] arrangement' is the extent to which the GPF exceeded the market rate.

[656] In this respect Mr Green submits that, if the GPF is deductible under specific provisions but is not at an arm's length amount, the Commissioner should have applied s GD 13 to reduce the deduction. That provision is the so-called transfer pricing mechanism which substitutes an arm's length amount for a non-arm's length amount paid in a cross-border transaction between associated persons. It provides as follows:

> (2) This section will only apply to require the substitution of an arm's length amount of consideration in the case of an arrangement—
>
> (a) Which involves the supply and acquisition of goods, services, money, other intangible property, or anything else; and
>
> (b) Where the supplier and acquirer are associated persons; and
>
> (c) Where the supplier and acquirer are—
>
> …
>
> (ii) A person resident in New Zealand and a person not resident in New Zealand unless—
>
> (A) The non-resident is entering into the arrangement for the purposes of a business carried on by the non-resident in

New Zealand through a fixed establishment in New Zealand; and

(B) The New Zealand resident has not entered into the arrangement for the purposes of a business carried on by the New Zealand resident outside New Zealand; or

…

(3) If the amount of consideration payable by a taxpayer under such an arrangement exceeds the arm's length amount, then for all purposes of the application of this Act in relation to the income tax liability for any income year of the taxpayer, an amount equal to the arm's length amount will be deemed to be the amount payable by the taxpayer in substitution for the actual amount.

[657] On Koch, for example, Mr Green says TBNZI is associated with KCS for the purposes of s GD 13. He relies also on a series of associations pursuant to s OD 8(3) and points out that TBNZI is a New Zealand resident while KCS is a non-resident. It follows that if a deduction is available for a GPF under the specific provisions, but the GPF is excessive in amount, s GD 13 should have been invoked: *CIT Financial*. The Commissioner cannot now, Mr Green says, by invoking s BG 1, disallow more than what is properly determined to be an arm's length amount.

[658] In my judgment Mr Green's careful argument must fail for these reasons. First, Westpac has failed to discharge its burden of proof. There is no reliable evidence to establish that, more probably than not, Koch would have proceeded without a GPF. An affirmative conclusion would be purely speculative.

[659] Mr Green is correct that earlier versions of the prototype Koch transaction omitted payment of a GPF. The first generic version was submitted in March 1997. Koch was not identified as a prospective counterparty until September. But no real progress was made until Babcock introduced the guarantee fee proposal in February 1998, changing it to a GPF in March. I infer that the introduction of that feature not only led to the proposal's revival but also its approval by the SFC committee within the next four months.

[660] The AIG proposal, sponsored by a different intermediary, was the only other relevant transaction. When submitted in May 1997 it expressly provided for

payment of a GPF to an AIG subsidiary. Again I can infer that that factor was a principal reason for generating Westpac's apparently preferred interest in AIG, leading to its decision in principle to proceed in late 1997.

[661] In summary, the evidence is, if anything, more consistent with a conclusion that the parties would not have entered into Koch without a GPF.

[662] Second, the principle which Mr Green seeks to draw from the *Europa* cases does not apply here. He cites this passage from the judgment of McCarthy P in *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 563 (CA) at 570:

> The Commissioner should instead have disallowed so much (if any) of the objector's fob costs in each year as exceeded the actual arm's length long term market values of the feedstocks in respect of which such costs were incurred.

[663] This statement was, however, made in a very different context. The Court was considering apportionment under a specific provision for deduction of expenditure necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving gross income: s 111 Land and Income Tax Act 1954 (then s BD 2(1)(b)(ii) ITA). The Commissioner had challenged Europa's ability to deduct the cost of oil feedstocks. The Court of Appeal found in Europa's favour on that issue (the Privy Council's decision, *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 546, delivered on 13 January 1976, was from an earlier decision of the Court of Appeal, reported at *Europa Oil (NZ) Ltd v Commissioner of Inland Revenue* [1974] 2 NZLR 737).

[664] I disagree with Mr Green that the second *Europa* case stands as authority for the proposition that the general anti-avoidance provision was not applicable to the extent of the amount of a deduction which was at an actual arm's length market value. The Court was determining an appeal against a decision on a case stated on the application of a specific deductibility provision. The general anti-avoidance provision was not then under consideration. The purpose of the judgment was to decide whether or not to revise the Court's earlier views expressed on that provision. The judgment is of no assistance here.

[665] Third, the information on which Westpac relies – Mr Seve's evidence given at trial that a true market value of the GPF was up to 1% of the transfer price – was not in the Commissioner's possession when he issued the reassessments. The time for the bank to establish the amount of the Commissioner's allegedly excessive reassessment, by reference to the so-called commercial value of the GPF, was in the notice or challenge period prior to the reassessments being issued. It was bound, if it intended to take that course, to specify the excessive component, and provide supporting evidence.

[666] The Commissioner was not able, when making the reassessments, to undertake the exercise now proposed by Mr Green because Westpac had not provided Mr Seve's assessment or its equivalent. Adoption of that course would, I accept, have been strategically unwise for the bank. But it is now too late to cure its omission.

[667] Fourth, in any event, Mr Green's argument for a deduction of that part of the GPF which was within a commercially justifiable range is contrary to s GB 1. The Commissioner has determined that Westpac's tax advantage was, as noted, for all deductions claimed on Koch. As I have found, he is not obliged to sever off part of a deduction on the basis that the expense might hypothetically have been incurred if the GPF was fixed at a market rate.

Result

[668] In the result, Westpac's challenge to the Commissioner's reassessments must fail. The bank has failed to discharge its onus of proving that the Commissioner erred, either in law or in fact. It may count itself fortunate that he did not, on his hypothetical reconstruction, disallow the bank's claim for its exempt income.

Summary

[669] In summary, I have found as follows:

(1) Westpac's claim for deductions for the GPF were unlawful, and the Commissioner is entitled to disallow them in entirety;

(2) In any event, Koch and the other three transactions were tax avoidance arrangements entered into for a purpose of avoiding tax;

(3) The Commissioner has correctly adjusted the deductions claimed by Westpac in order to counteract its tax advantage gained under an avoided arrangement.

Judgment

[670] It follows that I dismiss Westpac's applications on Koch, CSFB, Rabo 1 and Rabo 2 for an order cancelling or varying the Commissioner's amended assessment.

[671] Costs must follow the event. The Commissioner is entitled to judgment for his costs and disbursements. While, of course, the parties may wish to advance argument on the subject, I trust they will be able to agree. It may assist if I provisionally record that, given the complexities of the issues and argument, category 3C is the appropriate scale, and I would certify for three counsel. I am conscious also that a number of interlocutory steps have been taken by both sides.

[672] In the event that counsel are unable to agree on costs, I reserve leave to the Commissioner to file a memorandum on or before 3 November 2009 and Westpac to file a memorandum in answer by 1 December 2009. Memoranda are not to exceed 30 pages in length. On receipt of both I will confer with counsel for the purpose of arranging a fixture to hear oral argument. I trust, however, that a hearing will be unnecessary.

[673] I must conclude by expressing my gratitude to all counsel and those who assisted. Both cases were prepared and presented with great skill and care and the arguments were admirable; in my view, neither side could have been better served. In particular, I am conscious that I have rejected Westpac's primary arguments on all contested issues. That result, however, is solely a reflection of my findings about the

GPF and its consequences, and does not reflect on the submissions made by Messrs Farmer and Green. To the contrary, the length of this judgment is a tribute to the depth and quality of their arguments. Moreover, the spirit of co-operation and goodwill between counsel, which was in the best traditions of the profession, enabled the trial to proceed efficiently and cost effectively. It was a privilege to preside.

Rhys Harrison J