Commissioner of Inland Revenue v Frucor Suntory New Zealand Ltd

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I OVERVIEW

Frucor is an Auckland-based multinational business. It is the owner of numerous brands that will be familiar to New Zealanders, including V energy drinks, Boss coffee, and Fresh Up juice.[1] But this case is not about products that will help you to stay awake. Indeed, it may have the opposite effect, for it concerns the tax consequences of a financing scheme used to transfer funds between Frucor and its then-parent company, the Danone Group.[2]

The details of the financing scheme are complicated. Danone advanced $149 million to Deutsche Bank, which lent this amount alongside another $55 million to Frucor. Over the term of the loan, Frucor paid $66 million in interest to Deutsche Bank. Frucor later satisfied its obligation to repay the principal amount by issuing slightly over 1,000 shares to Deutsche Bank, which promptly transferred them to Danone, this having been a condition of the original advance of $149 million from Danone to Deutsche Bank. According to the Commissioner of Inland Revenue, the effect was that Frucor could plausibly claim a deduction for $66 million in interest payments rather than the lesser amount that would have been owed had the principal not been inflated by the additional funding contributed by Danone.

The Commissioner considered this to be tax avoidance, and thus allowed a deduction for the interest on the $55 million only. In the High Court, Muir J was not convinced. He ruled that, although aspects of the scheme were unusual, the Commissioner's reasoning was open to critique on two points.[3] First, the Commissioner had assessed the effect of the scheme in terms of its overall impact on the Danone group of companies, rather than focusing on Frucor.

1 See Frucor Suntory "Our Brands" <https://frucorsuntory.com>.

2 Danone sold Frucor to Suntory, a Japanese company, in October 2008. See "Danone sells Frucor for over $1.34b" Stuff.co.nz (31 January 2009), <www.stuff.co.nz>.

3 *Frucor Suntory New Zealand Ltd v Commissioner of Inland Revenue* [2018] NZHC 2860 [*Frucor (HC)*] at [156].

Secondly, the Commissioner had assumed that there was no cost to Frucor in issuing shares to Deutsche Bank, when in fact, it is widely accepted that issuing shares to satisfy a debt does not make interest payments on the debt non-deductible.

The Court of Appeal, on the other hand, accepted the Commissioner's reasoning in its entirety.[4] The case is currently on appeal in the Supreme Court, where the most likely outcome is that the Court of Appeal's decision will be affirmed. But academics have identified another issue that has gone unmentioned in the judgments so far. If the Court considers Frucor's financing scheme to amount to a tax avoidance arrangement, the scheme is "void as against the Commissioner".[5] Consequently, the Commissioner may adjust a person's taxable income "in order to counteract a tax advantage obtained by the person from or under the arrangement".[6] Yet the Commissioner has indicated that $11 million in interest deductions will be permitted to Frucor even if the Supreme Court rules in the Commissioner's favour. That may be inconsistent with the scheme being "void" and the power to adjust a person's taxable income being limited to adjustments that would "counteract a tax advantage".

For these reasons, the Supreme Court's judgment, which is due to be released later this year, could be of substantial interest to those who follow tax law. It may reveal the extent to which deductions can be claimed for hybrid inter- and intra-company loans; the correct approach to assessing tax avoidance when a New Zealand company is a member of a multinational group; and whether tax avoidance schemes are void entirely or only in part. In the meantime, this case note summarises the facts of the case and the issues it raises so that readers may better understand this intricate but important area of law.

II THE FINANCING SCHEME

A helpful diagram on the final page of the Court of Appeal's judgment summarises the scheme, which primarily involved Frucor, Danone Asia Pacific (DAP), and Deutsche Bank.

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4 *Commissioner of Inland Revenue v Frucor Suntory New Zealand Ltd* [2020] NZCA 383 [*Frucor (CA)*].

5 Income Tax Act 2007, s BG 1(1).

6 Section GA 1(2).

DAP became Frucor's sole shareholder in 2002. Almost immediately, executives began exploring possible ways to make more funding available to Frucor. One option was for Frucor to borrow money from a New Zealand-based bank, but the interest payments would have been a real cost to the group. Alternatively, DAP could have lent money to Frucor at below-market interest rates, but the relevant authorities would have easily identified this as tax avoidance. Conveniently, Deutsche Bank had previously assisted DAP in providing "tax-efficient funding" to an Argentinian subsidiary using a "convertible note structure". Over the year that followed, the two firms worked to adapt this model to local circumstances. It had two main components.[7]

First, the "convertible note deed". This was an agreement between Frucor and Deutsche Bank, according to which Deutsche Bank agreed to lend Frucor $204 million,[8] and Frucor agreed to pay interest at 6.5% over five years. The total interest cost was $66 million. After five years, the principal amount was to be repaid unless Deutsche Bank opted to receive 1,025 non-voting shares instead. It was common ground between the parties that the Bank would opt to receive the shares rather than the money.

Secondly, the "forward purchase deed". Conditional on agreement to the convertible note was a separate deed between Deutsche Bank and DAP. According to this deed, DAP agreed to pay $149 million to Deutsche Bank (on the issue date of the convertible note) and Deutsche Bank agreed to transfer the shares received from Frucor to DAP (upon maturity of the convertible note). If Deutsche Bank did not receive the shares, it was obliged to make a novation payment to another Danone Group member.

The convertible note deed was issued in March 2003, and, five years later, Deutsche Bank exercised its option to receive the shares, which were promptly passed on to DAP. Frucor also repaid the $204 million it had received from Deutsche Bank: $60 million to DAP via a share buy-back and $144 million to Danone Finance, an associated party. From Deutsche Bank's perspective, it had lent $55 million of its own money ($204 million to Frucor minus $149 received from DAP) and received $66 million back. The Danone Group had made $204 million available to Frucor, at a cost of only $11 million.[9]

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7 There were various other aspects of the arrangement, including loan funding from BNP Paribas and several guarantees, but they are less important.

8 Figures have been rounded for ease of reading.

9 Strictly, there was an additional fee to Deutsche Bank of $1.8 million for setting up the arrangement, as well as the interest on the loan from BNP Paribas.

III TAX AVOIDANCE

Frucor itself had received a $204 million loan, on which it had paid $66 million in interest. It claimed that the interest was tax-deductible. The central question in the case is whether this amounted to tax avoidance.

The Supreme Court outlined the correct approach to such questions in the 2008 decision of *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue*.[10] The Court must first consider whether the benefit claimed is consistent with provisions of the Income Tax Act, other than the general anti-avoidance provisions.[11] Both the High Court and the Court of Appeal considered the deductions to be allowable on this basis, as s DB 7 provides that a company is allowed a deduction for interest (subject to some exceptions not applicable here).[12]

The Court must then consider whether the taxpayer has used the specific provisions "to alter the incidence of income tax in a way that cannot have been within the contemplation of Parliament when enacting the provision".[13] Relevant factors include the manner in which the arrangement was carried out, the role of the parties and their relationship to the taxpayer, the economic and commercial effect of the transactions, the duration of the arrangement, and the nature and extent of its financial consequences. And it is the economic substance of the arrangement, not its legal form, that matters most of all.

On this point, judicial opinions varied. Muir J, while noting that there was an "element of circularity" to the scheme, emphasised that it was a "real" series of transactions with legitimate commercial purposes (such as making funding available to Frucor).[14] His Honour expressed his reservations as to two assumptions made by the Commissioner: that the correct unit of analysis was the Danone Group, rather than Frucor alone, and that the issue of shares to Deutsche Bank was costless.[15] Consequently, he held this the arrangement did not amount to tax avoidance.

10 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289.

11 At [103]–[108].

12 Contrast *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175.

13 *Frucor (CA)*, above n 4, at [27]. See also Ben Nevis, above n 10, at [107].

14 At [163].

15 *Frucor (HC)*, above n 3, at [156].

The Court of Appeal disagreed, although Gilbert J, who wrote the judgment, emphasised that Muir J was "an experienced commercial Judge" and that his decision was "careful, closely reasoned and comprehensive".[16] Nevertheless, the Court held that it was "reasonably plain that the funding arrangement had New Zealand tax avoidance as one of its purposes or effects and that this was not merely incidental".[17] Rather than focusing on Muir J's reasoning, the Court reached this conclusion after summarising some of the correspondence between the individuals who had established the scheme.[18] These documents show that the scheme had some decidedly unconventional aspects. As the Court put it:[19]

> ... the lender does not normally have zero credit risk and stand to profit from the transaction only by receipt of an upfront fee. Nor is it usual for the borrower to suggest the fee.

The parties had viewed the full deductibility of the interest paid by Frucor as a pre-condition to the arrangement proceeding, and the Court inferred from this that tax avoidance was a primary motivating factor. That said, limiting the parties' tax liabilities in other jurisdictions was also a consideration, as demonstrated by the decision for DAP to provide the funding. As DAP is based in Singapore, the receipt of the shares from Deutsche Bank would not have been a taxable capital gain.

Later in its judgment, the Court of Appeal responded to the concerns raised by Muir J. It agreed that it was appropriate to "examine Frucor's position on a standalone basis".[20] That is hardly surprising. But the Court also held that, in order to determine whether the payments were appropriately characterised as interest payments or a combination of interest and principal, a more holistic assessment was necessary. The Supreme Court is likely to revisit this issue, as the Court of Appeal's approach arguably amounts to saying one thing and doing another. From Frucor's perspective, the full $66 million *was* interest for the $204 million loan. But to focus solely on the New Zealand taxpayer would preclude the Court from considering the economic substance of the arrangement where it concerned non-

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16 *Frucor (CA)*, above n 4, at [107].

17 At [82].

18 See generally at [66].

19 At [67].

20 *Frucor (CA)*, above n 4, at [92].

resident entities.[21] Not only would that be contrary to *Ben Nevis*, it would be a substantial boon for those who engage in tax avoidance.

At the Supreme Court, Inland Revenue will have emphasised the movement of shares from Frucor to Deutsche Bank and then to DAP. Contrary to Muir J's suggestion, the shares were of no value to Deutsche Bank, as they conveyed no governance rights, and Frucor did not pay dividends. Besides, the Bank had agreed to transfer them to DAP. That suggests, in substance, the shares were not the principal to be repaid – and thus, that the $66 million paid to Deutsche Bank was not just an interest payment.

By contrast, Frucor's lawyers will have drawn attention to other aspects of the scheme that fit less neatly into the Commissioner's narrative. Notably, the $89 million loan from BNP Paribas to DAP, may indicate that the scheme's purpose was primarily to make funding available to Frucor. It is, after all, unremarkable for a member of a group of companies with easier access to external finance to borrow on an associated party's behalf. So too will Frucor have emphasised that the issuance of shares to a third party reduces the other shareholders' equity (even if, in this case, the loss was only temporary), contrary to the Commissioner's assertion that the issuance of shares was 'costless'.

The Supreme Court is most likely to affirm the Court of Appeal's decision. As Professor Michael Littlewood notes, "since the Supreme Court was established in 2004, the Commissioner has had an almost unbroken run of victories in tax avoidance cases".[22] If the proceedings so far are any guide, this case is likely to be no different. Frucor appears to have attempted to make principal repayments look like interest and has claimed a deduction for them. In its defence, the best it could argue is that, if the Court considers only part of the picture, the scheme is lawful. Judges are often inscrutable, but it is hard to imagine the Supreme Court agreeing to that.

IV THE RECONSTRUCTION PROBLEM

What remedy the Court should award is also in issue. If the Supreme Court agrees that the scheme was tax avoidance, it will be "void as

21 See Craig Elliffe "Discerning Commercial and Economic Reality: Applying the GAAR to Frucor" (forthcoming) at 14. Available at SSRN: https://ssrn.com/abstract=3833209.

22 Michael Littlewood "Tax avoidance" [2021] NZLJ 7 at 7.

against the Commissioner".[23] That precludes Frucor from receiving any tax advantage it would have gained from the scheme. How much tax the company should pay, however, is unclear.

One approach, the "annihilation theory," suggests that the Commissioner should disregard the transactions that make up the scheme.[24] However, this may reduce the taxable income payable by the company. The theory is easier to understand in cases where non-taxable income is earned through a tax avoidance arrangement. If the Commissioner simply disregarded the income because the arrangement is void, this would reduce the taxpayer's overall tax liability. However, it is doubtful that the annihilation theory makes sense in a case like *Frucor*, where the tax benefit arises from deductions rather than income.

Despite this and other issues with the annihilation theory, Parliament has included (since 1974) a 'reconstructive' provision that allows the Commissioner to:[25]

> ... adjust the taxable income of a person affected by the arrangement in a way the Commissioner thinks appropriate, in order to counteract a tax advantage obtained by the person from or under the arrangement.

This solution is just as controversial as the problem it aims to solve. The provision appears to permit the Commissioner to invent transactions that the taxpayer would have been party to had the taxpayer not taken part in the avoidance arrangement, and then to tax the person based on those transactions.

Here, the Commissioner has argued that the scheme is void, but that Frucor is nonetheless entitled to deductions of $11 million (which represents the interest paid on the $55 million loaned by Deutsche Bank). It is unclear why these deductions would not also be void if they were part of the arrangement. And if they are void, it is not clear on what authority the Commissioner intends to allow them. The Commissioner cannot rely on the reconstructive power, Professor Michael Littlewood argues, for the power is limited to inventing hypothetical transactions "in order to counteract a tax advantage", not

23 Income Tax Act, s BG 1(1).

24 Littlewood, above n 22, at 8.

25 Income Tax Act, s GA 1(2).

to selectively recognise transactions that have a favourable effect on the taxpayer.[26]

This view is not entirely persuasive. First, Frucor arguably would have borrowed this amount regardless of whether it entered into the more complex arrangement. That would suggest that the $11 million in interest could be considered separate from the arrangement, so the deductions would not be void.[27] Unfortunately, it is impossible to conclude with certainty what Frucor would have done had it not entered into the arrangement.

Secondly, suppose the Court takes the view, at an earlier stage in the analysis, that it should look to the "economic substance" rather than consider Frucor's position on a "standalone basis". In that case, it may be easier to convince the Court that the $11 million can be considered a legitimate interest deduction. In other words, the $11 million issue only arises if the Court rules against Frucor on the larger issue of whether the scheme amounted to tax avoidance at all. To reach that conclusion, the Court is likely to endorse a more holistic assessment of the scheme. A similar emphasis on the economic substance of the deductions might lead the Court to consider that the $11 million was a legitimate interest cost. It was, after all, paid in respect of funds loaned by the bank acting as such, rather than as an intermediary. That may be sufficient for the Court to rule that these deductions were not part of the arrangement. But the Commissioner could argue that, given that the participants in the scheme chose to lend the $149 million from DAP together with the $55 million from Deutsche Bank, Frucor should not benefit from the two being considered separately.

Thirdly, even if the $11 million in deductions cannot be considered separately from the rest of the scheme, the reconstructive power may allow the Commissioner to recognise the $11 million in deductions. The first part of the provision is expansive; Parliament appears to have intended the Commissioner to determine what adjustment should be made, subject only to a limitation in the second part of the provision that was presumably intended to ensure that the Commissioner does not go further than necessary to counteract the tax advantage.

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26 Littlewood, above n 22, at 8. This proposition has, to the best of the author's knowledge, received no judicial support in New Zealand, although it appears to be the most obvious reading of the statutory text.

27 Inland Revenue's Interpretation Statement on Tax Avoidance suggests that this approach is not permissible. See Inland Revenue *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (IS 13/01, June 2013) at [441].

However, the issue here is whether the Commissioner has gone far enough. Inland Revenue's Interpretation Statement suggests that the reconstructive power permits "reinstating legitimate tax outcomes voided by the arrangement."[28] In support of this assertion, the agency cites several cases. For example, in respect of an equivalent provision in an earlier Income Tax Act, McGechan J commented:[29]

> Where tax advantages are increased through avoidance over a base level which would have existed in any event, it is that increment above base level which is to be counteracted, not the legitimate base level itself.

The effect of this approach is that the test for reinstatement is the same as described above: it depends on whether the transaction "would have existed in any event".[30] Again, that is impossible to know for sure.[31] If Parliament intended this to be the correct approach, it might also be asked why the statute does not speak of counteracting an "illegitimate" tax advantage (or similar phrasing). At present, the section permits adjustments "counteracting a tax advantage", leading to reasonable doubt over whether any tax advantages may be lawfully reinstated.

Finally, it could also be argued that disallowing legitimate interest deductions claimed as part of a tax avoidance scheme would be unduly punitive. In a different scenario, the interest paid on funds supplied by the lender could be many times larger than the interest paid on funds supplied by the associated party. That would mean a finding of tax avoidance would cost the taxpayer dearly. However, the Commissioner could argue that this would simply provide a stronger incentive not to engage in schemes that may be considered tax avoidance.

Inconveniently, the Commissioner has not advanced these arguments, at least not before the High Court or Court of Appeal, nor has this particular issue been raised in any previous case. That makes it remarkably difficult to anticipate what, if anything, the Supreme

28 At [451]–[455].

29 *BNZ Investments Ltd v Commissioner of Inland Revenue* (2000) 19 NZTC 15,732 (HC) at [200] as cited in Inland Revenue, above n 27, at [453].

30 *Frucor (CA)*, above n 4, at [100].

31 Unhelpfully, Inland Revenue's Interpretation Statement merely notes that, although "legitimate tax outcomes" may be reinstated by s GA 1, "'[l]egitimate tax outcomes' do not include tax outcomes that are integral to the tax avoidance." What counts as "integral" is undefined. See Inland Revenue, above n 27, at [487].

Court will say about the problem. It seems likely that the Court will allow the $11 million in deductions, as this would be most consistent with precedent. That said, both of the possible reasons for doing so — severance and reconstruction — are troublesome, to say the least.

V CONCLUSION

In short, tax avoidance is a highly uncertain area of law. Whether an arrangement constitutes tax avoidance depends on whether the taxpayer has made use of specific legislative provisions in a way that Parliament would not have intended. If a company receives a loan, part of which originated from the company's own parent, and is satisfied by the issue of shares back to the parent, this may or may not be tax avoidance. It is up to the Supreme Court, in a judgment to be released later this year, to make the final decision. Hopefully, the Court will also take the opportunity to comment on whether, if the scheme is unlawful, the company can still benefit from deductions that would have been allowed had they not (arguably) been part of the tax avoidance arrangement. For the moment, all we can do is wait.