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IN THE SUPREME COURT OF NEW ZEALAND
I TE KŌTI MANA NUI

SC 81/2020
[2021] NZSC Trans 7

BETWEEN **FRUCOR SUNTORY NEW ZEALAND LIMITED (including as successor to Frucor Holdings New Zealand Limited)**
Appellant

AND **COMMISSIONER OF INLAND REVENUE**
Respondent

SC 92/2020

BETWEEN **COMMISSIONER OF INLAND REVENUE**
Appellant

AND **FRUCOR SUNTORY NEW ZEALAND LIMITED (including as successor to Frucor Holdings New Zealand Limited)**
Respondent

Hearing: 8-10 June 2021

Coram: Winkelmann CJ
William Young J
Glazebrook J
O'Regan J
Ellen France J

Appearances:	L McKay, M McKay and H C Roberts for Frucor Suntory New Zealand Limited J B M Smith, E J Norris and L K Worthing for the Commissioner of Inland Revenue

CIVIL APPEAL

MR L MCKAY

May it please your Honours. My name is McKay and I appear with my learned friends a second Mr McKay and Mr Roberts for Frucor.

WINKELMANN CJ:

Tēnā koutou.

MR SMITH QC:

E Te Kōti, ko Smith ahau. Hei kōnei mātou ko Ms Norris, ko Ms Worthing mō te Karauna.

WINKELMANN CJ:

Tēnā koutou. Mc McKay.

MR L MCKAY:

Thank you, your Honour. If I may commence your Honour with a housekeeping point?

WINKELMANN CJ:

Yes.

MR L MCKAY:

My friend and I have considered the question of timing of the respective appeals and although the timing is ultimately of course for your Honours, nevertheless it's our expectation that the appellant's submissions on the, I call it the substantive appeal, should complete sometime between three and three

30 this afternoon and my friend would then commence to put the respondents, the Commissioner's position, on the substantive appeal. It is expected, as far as we can tell and of course always subject to your Honours that by 2.30 tomorrow the submissions, including the reply submission on the substantive appeal will be over. My friend will then commence to put the Commissioner's submissions on what's called the shortfall penalties' appeal. So subject, of course, to the way in which the arguments develop, and your Honours' preferences, that's our expectation as to the way and the timing in which the appeals will be pursued.

WINKELMANN CJ:
Well having reviewed the material, we did think it was quite a generous time allocation, but we will see if we are wrong about that.

MR L MCKAY:
All right.

WINKELMANN CJ:
And, as you say, some of that is in our own hands.

MR L MCKAY:
Okay, so I think without more ado I will commence your Honour. Your Honours have the, of course, have the appellant's written submissions. In paragraphs 1 and 2, the appellant summarises what it regards from its perspective as the two principal issues raised on the appeal. The first of them is whether or not the Court of Appeal was correct in holding that the arrangement that I will be discussing in more detail obviously, that that arrangement was a tax avoidance arrangement for the purposes of section BG 1 of the Income Tax Act 2007 and the second submission is that if the arrangement is in fact a tax avoidance arrangement, the submission is that the tax reassessments effected by the Commissioner with reference to it are not a proper exercise of her reconstruction powers pursuant to section GB 1.

Your Honours, it's convenient to take your Honours to the three statutory provisions that really form part of the amalgam of tax avoidance arrangement definitions. Your Honours will be of course aware of them, but it's an appropriate place to start. There is a, in volume 1A of the appellant's bundle of authorities the three relevant definitions are set out. That's volume 1A.

The first of them, your Honours, is at tab 1 and that sets out the short terms of section BG 1 and BG 1 provides two things relevantly for this appeal. In subsection (1) that: "A tax avoidance arrangement is void as against the Commissioner for income tax purposes," and it provides in its subsection (2) that: "The Commissioner may counteract a tax advantage that a person obtained from under a tax avoidance arrangement," and we will see that that is the province of subpart GB of the Act. So that's the tax avoidance arrangement definition. I beg your pardon, the tax avoidance voiding provision.

If your Honours would then turn to tab 4 of that same volume, your Honours will see that the terms of section GB 1 which is loosely called "the reconstruction provision", is set out and I will come back to that subsequently in the appellant's submission, but it's the first six lines that give a sense of where this provision fits in the tax avoidance arrangement framework where an arrangement is void in accordance with section BG 1 which is the provision I have just taken you to your Honours: "The amounts of assessable income deductions included in calculating the taxable income of any person affected by the 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 and under the arrangement," and then it goes on, but that's the primary power conferred in section GB 1 in circumstances where the Commissioner does reconstruct the arrangement.

The final provision in this suite, as it were of the tax avoidance framework, is at tab 6 of that same bundle of authorities and it's the definition of tax avoidance arrangement. Your Honours, recalling that in terms of section BG 1, which is the provision I took you to at the outset, what is void as against

the Commissioner under that provision is a tax avoidance arrangement. The definition of "tax avoidance arrangement" is contained at tab 6 in section OB 1 and it's an arrangement that has tax avoidance as its purpose or effect, or an arrangement which has tax avoidance as one of its purposes or effects whether or not any purpose or effect is referable to ordinary business or family dealings if the purpose or effect is not merely incidental. Now, your Honours, I will be coming back to all three of those provisions at various points in my submission, but that's in broad terms the framework for a tax avoidance analysis, at least in terms of the statutory provision as I will submit in a moment.

The case law framework, working in tandem with that is that of course of this Court's decision in *Ben Nevis Forestry Ventures Ltd* v *Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289.

Your Honours, I want to introduce the appellant's case by briefly summarising the facts and evidence relating to Danone and I call Danone the French parent company of the Danone Group which includes all of the known entities that are referred to in the submission, the structure adopted by Danone Group of the acquisition of the Frucor New Zealand business in 2002, I then want to move equally briefly to summarise the arrangement put in place in the following year which was 2003 to refinance that acquisition capital structure and then I want to equally briefly take you to the two principal documents by which the arrangement was effected.

If your Honours would turn, and I'm dealing now with the written submission of the appellant, if your Honours would turn to paragraphs 5 and 6 of that document, the intervening pages representing just the summary of the submission. Turning to paragraphs 5 and 6 your Honours will see that the Danone Group acquired a company called Frucor Beverages Group Limited in January 2002 for almost $300 million. Repeating that was a local entity, Danone is a French and international business. That funding of the almost $300 million purchase price was divided 50/50 debt and equity. The 50% equity as is said in paragraph 6, was contributed by a Danone company which

is referred to and I think it's in both parties' written submissions as DAP. It's a Singaporean Danone entity by the name of Danone Asia Pte Limited. So that was the source or contributor of the equity for approximately $150 million. Sorry, not approximately, for exactly 150 million in equity capital.

The other approximately 150 million, as I say in paragraph 6, was contributed in the form of debt by another Danone entity, an entity situated in France named Danone Finance S.A. and there was a reasonably detailed cash management agreement for the to and froing of surpluses between the parties, but I don't think I need take you to that. That was the debt instrument under which the second tranche of acquisition funding was contributed. So, that's the pre-arrangement financing.

The arrangement arose out of discussions between Deutsche Bank and Danone Group, or Danone in France, almost contemporaneously with the acquisition of the Frucor business.

The principal steps in the arrangement, your Honours, if you would turn over to the diagram on page 5 of the written submission, the principal steps of the arrangement are marked in red, if the colour has come through to your Honours' copies. Under the arrangement, and if we go right to the bottom of the page and we're looking at the moment at the red lines, under the arrangement Deutsche Bank, and it doesn't say so here, but it was Deutsche Bank through its New Zealand branch, as your Honours know, same entity as Deutsche Bank but it was through its New Zealand branch operation, paid or advanced 204 million to the Frucor New Zealand business. Also going up the diagram and again following if you might the red lines, that 204 million was available or made available to Deutsche New Zealand branch through two sources. The first source, looking at the left-hand red line, was a payment by DAP which you will recall is the Singaporean Danone entity, the holder of all of the equity in the New Zealand business, a payment by DAP of 149 million and that payment took place under an instrument called a forward purchase deed, forward purchase deed, that I will take you to momentarily.

The second source of the 204 million advanced by Deutsche New Zealand to Frucor was an internal, I call it borrowing, but internal facility made available by Deutsche Treasury to Deutsche New Zealand branch and the amount of that was 55 million which together with the 149 million contributed by DAP under the forward purchase deed comprised the 204 million subscribed by Deutsche in the bottom line to the Frucor New Zealand business.

Your Honours, just one more step with reference to this diagram and I'm looking now at the bottom green entries, these green entries being denoting or denoting transactions or cash flows that occurred over the life of the arrangement. Over the five year period of the convertible note, Frucor New Zealand paid $66 million interest on the 204 million convertible note subscription. It was a design feature of the arrangement that that 66 million interest by Frucor would be employed by Deutsche New Zealand branch to pay interest on the 55 million, I will call it borrowing, from Deutsche Treasury and also to amortize that 55 million borrowing. In other words, it was intended as a matter of financial mathematics that the 66 million interest by Frucor would fully amortize the 55 million borrowing and pay interest on the outstanding reducing balance of that 55 million advance from time to time.

Your Honours, just making use of the diagram for one more purpose. It's not shown here. It's actually shown in Muir J's equivalent diagram but let's not turn to that. What happened to the 204 million? That's again the red line, the amount subscribed by Deutsche Bank for the convertible note. It was applied by Frucor New Zealand for two purposes. One of them was to repay the Danone Finance cash management facility which by the time of this arrangement in around early 2003 sat at 144 million debt, amounts owing by Frucor New Zealand to Danone Finance, so it repaid that and the remaining 60 million was employed by Frucor New Zealand to redeem 60 million of the 105 million establishment equity contributed by DAP. So the aggregate of 204 used to repay the existing debt lines to Danone and to redeem 400 of the establishment equity shares. So, amongst its other effects, it will be obvious just from the numbers that there was an element not only of refinancing, but of increasing the level of debt in the Frucor New Zealand business. It started out

in 2002 at 50/50 debt and equity as the result of the arrangement and the introduction of greater debt and the partial reduction of acquisition equity, the ratio ended up around 63 debt, 37 equity.

Your Honours, as the final step in that introduction that I have foreshadowed five minutes or so ago, can I take you to the two principal documents, contracts, by which the arrangement was affected. They are first the convertible note substitution agreement which was the source of Deutsche New Zealand's 204 million subscription and secondly, the forward purchase deed between DAP and Deutsche. I'm sorry, I'm going to be moving backwards and forwards. I will try and transpose some of that bundle to here.

The first of those agreements is the convertible note agreement and that's set out in tab 2 of volume 3A on the case on appeal. Tab 2, volume 3A case on appeal.

GLAZEBROOK J:
Would that just come up as volume 3 on our electronic?

MR L MCKAY:
Sorry, if you're asking me I don't know.

WINKELMANN CJ:
It is. It's the second thing in my…

O'REGAN J:
It's 301.0002.

MR L MCKAY:
You'll see it's an agreement between Danone Holdings New Zealand through a variety of name changes that have taken place since 2002, I'm just calling that Frucor New Zealand, and Deutsche Bank New Zealand branch. If you look at the preambles on the first substantive page of the deed, that's page 1

of the deed, the companies agreed to issue and Deutsche Bank has agreed to subscribe for a convertible note.

Turning the page, if you look at the first of the left-hand side of the definition clause within the agreement, you'll see that the interest rate attaching to the 204 million advance is 6.5 per annum. If you look further down that page you will see that the instrument has a maturity date of the fifth anniversary of the note, so it's a five year convertible note and, as I said before, if the principal amount was a number, it's 204 million, but it's in fact on the right-hand side on page 3 of the instrument, it's a, I think in the Court of Appeal's term "a very exact number". It is 204,421,565, being the principal amount of the note.

If you turn over the page to clause 2 of the agreement your Honours, you will see clause 2 is the principal operative agreement. It provides for the company which is the Deutsche, I beg your pardon, which is the Frucor party, will issue the note and it provides that Deutsche as investor will subscribe for the note.

If your Honours look over to the next page which is page 5 of the deed, you will see the redemption provisions in clause 5 of the agreement. Pursuant to clause 5.1, if it's redeemed for cash, then subject to acceleration events, it's going to be that 204 million redemption amount.

But significantly, if your Honours would look at page, at clause 5.2, it provides that: "If the investor has given the company written notice of not less than 10 business days prior to the maturity date that it elects to have all of the obligations of the company in respect of the principal amount satisfied by the issuance of shares then the company shall issue to the investor the shares on certain timeframes." So, obviously 5.2 can be made the governing provision and therefore in effect it was the governing provision because it was clause 5.2 that was actually exercised in this case which confers upon the investor Deutsche Bank a right to elect shares. The rest of the agreement for our purposes, or current purposes, your Honours, I will say is in standard form.

The second of the principal agreements by which the arrangement was effected is at tab 3 of that same bundle of the case on appeal.

WINKELMANN CJ:
That's 301.0033.

MR L MCKAY:
I'm sorry, I do not have the numbers. I'm dependent on – thank you, your Honour. It's a forward purchase deed. You will recall in the diagram I said there was a forward purchase deed entered into between DAP as the Singaporean parent company of the Frucor New Zealand and Deutsche Bank. Well, this is that instrument. This is the instrument that provided 149 million of the 204 million financing or funding for Deutsche Bank to subscribe to the convertible note. The recitals which are on page 2 of the agreement, recitals record the convertible note deed and then recite that the buyer which is DAP: "The buyer wishes to purchase and the seller wishes to sell the shares on subjective terms and conditions set out in this deed."

So, looking at the thing generally, at the instrument generally, your Honours, it's an agreement entered into by DAP to acquire the shares which will occur, or are intended at least to occur, are expected to occur, upon the conversion of the convertible note which is our first instrument.

Over the page, the purchase price, half way down the page, your Honours, that's the 149 million that is paid by DAP to Deutsche Bank New Zealand branch.

Turning over the page to page 5 you will see in clause 3, 3.1, that the parties have agreed to that purchase and that the buyer, that's DAP will pay now the 149 million purchase price. You will see in the balance of clause 3 that although, as I had earlier indicated, it was the very firm intention and expectation of the parties that Deutsche Bank would elect to redeem the note by giving notice to Frucor New Zealand that redemption should be by way of conversion by way of the issuance of shares, that there are two other ways

that the forward purchase obligations could be completed. 3.2 is obviously the most important one. That's completion by transfer of shares and it's saying that if in fact all goes to plan and expectation and Deutsche Bank does give notice under the convertible note deed that it elects to convert by shares, then it will have the shares and it will immediately pass those shares to DAP in discharge of the obligations under the forward purchase deed. But for reasons that I think it was Justice Gilbert in the Court of Appeal described as "possible doomsday events", other, two other forms of completion of the forward purchase agreement are contemplated and very briefly, the first of them is in clause 3.3 of the forward purchase deed completion by payment of novation amount and this contemplates a situation where Deutsche Bank New Zealand elects to convert, in other words, to have the shares issued, but they don't in which event Deutsche Bank pays the 204 million that it receives by way of cash conversation, or cash redemption, passes that on to another Danone party which is the other party to the deed which is Compagnie Gervais Danone, a wholly owned subsidiary of Danone Group, and that company which is called the novation counterparty in the agreement, assumes all of Deutsche Bank's New Zealand obligations under the forward purchase agreement. So, it's a case of Deutsche Bank saying: "Well, we elected that redemption would take place by way of conversion. We elected to have the shares to give to you but for some reason they couldn't and therefore, all we have to do is now pass the 204 million on and you, Danone, effectively internalise the issue between your own wholly owned group companies."

The final, or the third and final method of completion contemplated by the forward purchase deed is set out on page 6. It's in clause 3.4 and what's been contemplated in this even more Armageddon style scenario of clause 3.4 is the situation where for some reason Deutsche Bank New Zealand does not give notice to redeem the convertible note through the issuance of shares and I think again it was Justice Gilbert in the Court of Appeal who at least in discussion with counsel suggested that could only be in a circumstance where in a true Armageddon and doomsday situation, that Deutsche Bank would prefer to occupy the status of a debt creditor, if I can put it that way rather than

the holder of shares in the Frucor Danone New Zealand business. So it's apparently a very, very unlikely situation to arise.

It's even more unlikely to arise because there is a financial penalty imposed upon Deutsche Bank New Zealand in the circumstances contemplated in clause 3.4. So Deutsche Bank, in the circumstances discussed in that paragraph, if they arose, would have an obligation to gross up for Singaporean tax the Singaporean tax that would arise to DAP through its cash receipt of 204 million and that's too oblique. Let me just try that one again. Under clause 3.4 Deutsche Bank receives the 204 million because it has not elected shares. It passes the 204 million into Danone Group, DAP, as partial discharge of its obligations to DAP under the forward purchase agreement. It is a matter of Singaporean law, because it's now receiving cash rather than shares, DAP is taxable in Singapore on the difference between its 149 million investment which it made on day one under the DAP, under I beg your pardon, under the forward purchase agreement and the 204 million cash. So the financial penalty to Deutsche that caused all this problem and documentary contemplation because it didn't issue a conversion notice to convert for shares is liable to gross up the Singaporean recipient.

I haven't taken you to the other methods of completion under the forward purchase agreement. I don't intend to suggest that any of the, or either of those events or scenarios were likely. It was the parties' expectation and intention that Deutsche Bank would give notice under the convertible note, would elect conversion or redemption by way of the issuance of shares, would receive the shares and pass them on to DAP pursuant to the forward purchase agreement.

O'REGAN J:

In the structure, the Deutsche Treasury and Deutsche New Zealand branch are the same legal entity, are they?

MR L MCKAY:

Yes, they are. Yes, as a branch operation. At least they are in real commercial terms. Deutsche New Zealand branch therefore has effectively the benefit of the balance sheet of Deutsche Bank as a matter, and it's not an irrelevant matter if I might say so, Sir. It's a matter of New Zealand tax law.

GLAZEBROOK J:

Mr McKay, can you just make sure you speak into the microphone. I can hear you but I'm just worried that it's not being picked up on the transcript.

MR L MCKAY:

All right. Yes. As a matter of New Zealand tax law, without doubting that they are the same legal entity, the various treaties, including the treaty with both Singapore and Germany that New Zealand has, requires that even though it's a branch, the same legal entity, that in all its dealings with, certainly with New Zealand residents like Frucor New Zealand, that it operates on an arm's length basis. So it's treated in some respects as if it were separate for income tax purposes but it undoubtedly, in business and legal contemplation is the same entity as Deutsche Bank.

Well, in the interests of time, that's a brief introduction to the nature of the arrangement and the nature of the documents that effected it. I am now at page 16 of my written submission.

WINKELMANN CJ:

16?

MR L MCKAY:

16, I'm sorry, yes, your Honour, 16.

WINKELMANN CJ:

Paragraph 16 or page 16?

MR L MCKAY:

I'm sorry, no of course you're right, paragraph 16.

WINKELMANN CJ:

I did think we're making extraordinary progress.

MR L MCKAY:

A collective wish it were otherwise no doubt. I mentioned before that there were two elements effectively to the framework for considering a tax avoidance analysis. I took you through the statutory elements of that which were the definitions of tax avoidance arrangement BG 1 and GB 1. I also mentioned in passing that there was a second element of a tax avoidance analysis framework and that that was represented by the decision of this Court in *Ben Nevis Forestry Ventures*, and although the case will be well known to your Honours, I do want to spend five minutes or so just taking your Honours to that decision and referring to a number of elements of the directions or guidance afforded by the majority judgment of this Court in terms of the general approach, the general directions as to how one tackles a tax avoidance analysis, how one applies those spare and short provisions that I've already taken you to, to an actual fact, evidence in documentary situation.

WINKELMANN CJ:

So, you can proceed on the basis that we've read all these cases.

MR L MCKAY:

Yes. I was planning to take you to four reasonably short paragraphs of it, your Honour.

WINKELMANN CJ:

Go ahead.

MR L MCKAY:

Thank you, but I get the message your Honour. It's volume 1A of the bundle of authorities, 1A of the bundle of authorities at tab 8 and I want to focus as I

said to her Honour the Chief Justice, I want to focus on four short extracts of the majority decision that are in my submission are of principal relevance to this appeal. Principal relevance because they relate to, in a sense, the difference between the appellant's position on this appeal and the position adopted by the Court of Appeal and by the Commissioner on the appeal to this Court and they are in a sense the respective significance or importance of the particular provisions which presumptively, at least at first instance, determine the tax character of the arrangement relative to more general notions of, if I call it, the economic substance of the arrangement itself. What is the relationship between the two of them? Often not significant, and I respectfully suggest and I will develop the point a little later, but I respectfully suggest that in *Ben Nevis* itself and in *Glenharrow Holdings Ltd* v *Commissioner of Inland Revenue* [2008] NZSC 116, [2009] 2 NZLR 359 and in *Penny v Commissioner of Inland Revenue* and *Hooper v Commissioner of Inland Revenue* [2011] NZSC 95, [2012] 1 NZLR 433, that relationship was not critical partly because of the paucity or sparsity of any particular charging provisions to discern Parliament's intent and contemplation and purpose from. In the event, let me just briefly take you to the four relevant sections if I might.

The first of them, and I've tried to summarise it in paragraph 17, but in fact it's better to use the Court's own words. The first of them relates to the two stage nature of the enquiry and that's set out on paragraph 107 of the majority's judgment at the reference that I've given to you.

"When", as here, "a case involves reliance by the taxpayer on specific provisions, the first enquiry 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 upon 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". That's the two tier, or the two enquiry step from *Ben Nevis*.

The second relevant paragraph your Honours is over the page at paragraph 109: "In considering these matters which are the matters specified in paragraph 8, 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," and those are probably the two, if I call them famous paragraphs from *Ben Nevis.* They are certainly the paragraphs that are generally treated or pointed to as encapsulating the essential elements of the *Ben Nevis* analysis and they are attempted to be summarised in the written submission at paragraph 17.

Your Honours, I mentioned there were four. There are two others that I take you to. They are equally brief. The first of them is in paragraph 103 of the judgment and this relates more particularly to again that relationship matter that I mentioned, the relationship between the specific provisions and a broad perception, or a broad characterisation of economic substance. We consider Parliament's overall purpose is best served by construing specific tax provisions and the general anti-tax avoidance, I beg your pardon, the general anti-avoidance provision so as to give appropriate effect to each. They are meant to work in tandem. Each provides a context which assists in determining the meaning and in particular, the scope of the other. Neither should be regarded as overriding, rather, they work together.

WINKELMANN CJ:
And that can be contrasted to the approach of the minority who thought that you could also pursue anti-avoidance through the individual provisions?

MR L MCKAY:
Through the specific provisions?

WINKELMANN CJ:
Yes.

MR L MCKAY:
Yes, that's right. That's right, your Honour. Yes, your Honour, it is fair to say that at a general level, that is the difference between the minority and the majority judgment.

The fourth and final of the extracts from *Ben Nevis* that, in the appellant's submission is relevant your Honours, is paragraph 104 of the majority's judgment and it's in part directing at the same issue as that in paragraph 3. Parliament must have envisaged that the way a specific provision is deployed would in some circumstances cross the line and turned what might otherwise have been a permissible arrangement into a tax avoidance arrangement. Ascertaining when that will be so should be firmly grounded in the statutory language of the provisions themselves.

Your Honour, it obviously has no authority relative to the judgments in *Ben Nevis* but as part of the, if I can call it the legal framework aspect of the analysis, I propose to take you very briefly again to the Commissioner's interpretation statement on section BG 1 following the decisions of this Court in *Ben Nevis* and *Glenharrow* and *Penny* and *Hooper.* The Commissioner issued an interpretation statement out of her office of the Chief Tax Counsel for the double purpose as all her interpretation statements do of informing the Commissioner's officers as to the Commissioner's official position on, in this case, the three Supreme Court decisions and also advising taxpayers as to the interpretation of those decisions that the Commissioner proposed to take.

Now, this Court of course will say they're either right or wrong. I mean that's not that for any authority here, but there are extracts in those statements that go directly to the question that I was attempting to put to your Honours a moment or two ago. What do you do, or how do you go about integrating determining the relationship between Parliament's intent and contemplation with reference to the specific provisions that will be or are of relevance to the

arrangement before you and what was identified in *Ben Nevis* in its paragraph 109 as the economic and commercial reality of the arrangement and the Commissioner, I will just leave you if I can with references to the appropriate sections of the interpretation statement. It's set out, and I will take you there but only very briefly, it's set out at tab 21 of volume 2 of the appellant's bundle of authorities, that's tab 21, volume 2 of the appellant's bundle of authorities and the references I will leave with you are two paragraphs, 210 through to paragraph 213. That's 210 through to 213 and the particular segments of it which, as I say well for me it's worth a lot because it's expert guidance as to the Commissioner's view on the provision. It's not the same position of course for your Honours, but the Commissioner does address in these paragraphs how, in her view, following those three Supreme Court decisions one goes about determining whether when you reach your second stage *Ben Nevis* analysis, when you're looking at the facts and documents with reference to that arrangement, how it is that you integrate what you have determined to be the purpose and contemplation of Parliament with reference to the specific provisions with that more general enquiry and I suppose your Honours, the point that I want to make, or the paramount point I want to make with it is that the Commissioner addresses in these paragraphs the sequence. Do you do as I respectfully suggest the Court of Appeal did in the present case go straight to a determination of the economic substance of the arrangement, or do you at some point have to pause along the way to have regard to the specific provisions of the legislation that are engaged by the arrangement, draw whatever inferences are reasonably available from those specific provisions and take the position that they inform Parliament's purpose and contemplation at the second stage enquiry? The Commissioner herself, for what it is worth – sorry, I don't mean to trivialise that, it's just obviously not this Court speaking, but the Commissioner herself takes the view that it is necessary that the first of the enquiries is in terms of the particular provisions and the particular contemplation drawn from them and I will see if I – in paragraph 212, since I have asked your Honours to go there, six lines, seven lines down: "In the Commissioner's view it is preferable and even necessary to consider first Parliament's purpose for the provisions that issues before the commercial and economic reality of the arrangement is

examined. The main reason for this is that Parliament's should, as a matter of logic and principle, guide the enquiry." And a similar theme developed in the balance of that paragraph and in paragraph 213.

Well, independently of the authority of the Commissioner's views to that effect in those two paragraphs, your Honours, and just stepping back to those extracts from the *Ben Nevis* majority judgment that I referred you to, it is in my respectful submission very clear when one examines the approach adopted by the Court of Appeal that there is insufficient frankly, if any, regard paid to the specific provisions of the legislation as they apply to the arrangement to satisfy, to even a small, to any extent, the *Ben Nevis* directions with reference to the two stage enquiry, the in tandem operation of the specific provisions with the general anti-avoidance provision and the direction that they work together in a tax avoidance analysis because the Court of Appeal doesn't examine them in any substantive sense.

What it does do, and I'm now paragraph 23 of the written submission, what it does do is recharacterise the transaction and apply section BG 1 to that recharacterised transaction without adopting, in the Commissioner's language again: "The necessary step of examining the specific provisions as they apply to the arrangement in the first instance unamended, or uncharacterised by section BG 1," because this throughout was the Commissioner's submission in the Court of Appeal. In paragraph 23, the Commissioner claims that: "As a matter of commercial and economic reality, the 66 million coupon payments represented principal and interest payments required to repay an amortizing loan from Deutsche Bank of 55 million." She says that: "The balance of 149 million received from Deutsche Bank to make up the 204 million advanced on the note was effectively paid to Frucor by its 100% parent DAP for the issue of 1,025 shares in Frucor at the expiry of the arrangement in year five at a pre-agreed price of 204 million." And you'll see, your Honours, from paragraph 24 that the Court of Appeal adopted the Commissioner's submission in materially the same language as the submission itself. In other words, there was, in reality, a 55 million loan from Deutsche Bank and as to the 149 million, well, Deutsche Bank was a conduit for that it passed through

Deutsche Bank from DAP but what it was, was an equity subscription, a payment now for the issuance of shares in five years' time.

WINKELMANN CJ:
Can you clarify for me which provisions of the Income Tax Act you say the Court of Appeal should've conducted the stage 1 *Ben Nevis* enquiry in respect of?

MR L MCKAY:
Yes, and that's the next almost immediate section that I'm moving to.

WINKELMANN CJ:
Because I think there's a significant difference between you and the Commissioner on this point.

MR L MCKAY:
Yes, but I will answer the question, but I will be picking up literally in one moment.

WINKELMANN CJ:
It's okay, if we're moving to it, that's fine.

GLAZEBROOK J:
If it was a subscription of shares that were worth 204 even as an agreed price, if it had occurred in New Zealand, the difference between the 149 and the 204 would've been accrual interest, right?

MR L MCKAY:
Yes.

GLAZEBROOK J:
So, effectively, there would've been an interest element and apparently that is not characterised as interest in Singapore, but effectively economically it is interest?

MR L MCKAY:

Yes, it is and it shows in the financial accounts of the Singaporean entity as interest. Earnings at least.

GLAZEBROOK J:

And of course there's issues about valuation?

MR L MCKAY:

Yes, yes, which again Ma'am, I come to.

GLAZEBROOK J:

Just as a matter of something, if you have a forward purchase, the excess is interest?

MR L MCKAY:

Yes and if I might go back to, if I can, that is the point included in the points that I'm going to move onto your Honour. What are the specific rules? Sorry, I haven't moved to here but I'm going to, they are the financial arrangements rules that Justice Glazebrook referred to among the specific provisions of that regime, which is a hugely important regime in terms of the taxation of debt instruments, particularly international debt instruments, among those provisions is precisely the specific provision that Justice Glazebrook referred to and that is presumptively at least under that rule. If you put 149 million in now, and it doesn't matter about shares, that is just a form of property, you put it in now, it's a debt and it's characterised – I'm sorry, I keep moving away from this – it's characterised by the financial arrangements rules as debt. Assuming the, can I call it the integrity of the 204 –

WINKELMANN CJ:

Sorry, what is characterised as debt?

MR L MCKAY:

The 149 million and what I think, please correct me if I'm wrong Justice Glazebrook, what I think Justice Glazebrook was saying is if one looks, were suggesting as a possibility, if one looks at the Commissioner's argument summarised in paragraph 23 of the written submission and adopted by the Court in the extract in paragraph 124, I beg your pardon, 24, it characterises the 149 million payment by DAP to Deutsche Bank as a payment on day one for the issue of shares in five years' time and Justice Glazebrook mentioned that again subject to what I will term in the submission later, the lowest price clause, that is presumptively a situation in which interest, or interest-like earnings, arise to the depositor under the financial arrangements rules. Those rules apply to debt and debt-like instruments. They certainly apply specifically in terms of some of the determinations issued by the Department to what are called forward purchase agreement, including agreements of shares. Under those rules, the 149 million, let's assume for the moment, grows to 204 million over the five year period of the instrument from the standpoint of, can I call it the depositor, the payer, DAP who made the day one payment, it's interest income. Critically, from the standpoint of the recipient of the 149, it's a loan and the difference between the 149 million day one receipt and the 204 million for value payment at the end of five years is deductible interest which under the financial arrangements rules is spread over the term of the instrument and those are among the specific rules –

WINKELMANN CJ:

So that's in New Zealand?

MR L MCKAY:

– that in my respectful submission the Court of Appeal simply had to take into account at a first stage and a second stage analysis in *Ben Nevis* terms.

WILLIAM YOUNG J:

Haven't the Court of Appeal effectively taken the view that the deductibility provisions you rely on are premised on an orthodox convertible note

structure? That is one where the investor has the conditional purpose of obtaining shares in the issuer?

MR L MCKAY:
Certainly, Sir, they regard the use of the convertible note as an –

WILLIAM YOUNG J:
A contrivance.

MR L MCKAY:
I beg your pardon, Sir?

WILLIAM YOUNG J:
As a contrivance?

MR L MCKAY:
Yeah, I suppose yes, it's certainly regarded as an unusual feature. They certainly accept that it's not, this is not the situation, the type of arrangement where a convertible note would conventionally be issued.

WILLIAM YOUNG J:
So that's the Court of Appeal's view, isn't it and you accept that, I take it?

MR L MCKAY:
Well, they certainly say it's artificial, Sir, yes.

WILLIAM YOUNG J:
So, is this debate really, I mean is it really that profound? Haven't the Court of Appeal simply proceeded on the basis just as the licence to occupy land in *Trinity* wasn't an orthodox licence of the kind envisaged by the statute that here the convertible note structure put in place was not of a kind envisaged by the legislature?

MR L MCKAY:

Yes, and that materially assist though, your Honour, if the Court of Appeal had examined whether any of the specific rules that apply to determine the consequences of a convertible note, including determinations issued by the Commissioner with reference to them, place any significance at all on whether or not those notes, or any other of the instruments comprising debt instruments were restricted or not restricted to related parties or unrelated parties.

WILLIAM YOUNG J:

It doesn't matter that it's related parties or not, it's just that on the Court of Appeal's approach the convertible note really doesn't have any economic substance because Deutsche Bank never intends, other than momentarily, to hold the shares?

MR L MCKAY:

With respect, Sir, what the Court of Appeal should've done then, if it had taken that view, would've been, should've been to remove that element of whether it's contrivance or whatever, remove that element of contrivance and ask: "All right, let's let Parliament's intended contemplation by asking what would the tax consequences have been if there had been a direct subscription, not through Deutsche Bank, but a direct subscription by DAP.

WILLIAM YOUNG J:

But, sorry I understand that argument because these are the sort of counterfactual arguments.

MR L MCKAY:

Yes.

WILLIAM YOUNG J:

Whereas the Commissioner's response is simply in substance this was a loan of $55 million, that's the only new money that really comes into the system

and it's repaid and low and behold the principal repayments have been claimed as deductions and that's quite a simple argument.

MR L MCKAY:

Yes, but, with respect, Sir, if the Court of Appeal said that, they'd be wrong because –

WILLIAM YOUNG J:

They did say that though, didn't they?

MR L MCKAY:

Well I'm not hiding from the fact, but I think they were with respect wrong, Sir. But I mean the premise on which that's based is that this is a loan of 55 million. It's not. 204 million came in on day one. 204 million –

WILLIAM YOUNG J:

But 149 million went round in a circle and went back to Deutsche Bank on day one?

MR L MCKAY:

No.

GLAZEBROOK J:

That's what happens with refinancing always.

MR L MCKAY:

144 million, if we treat –

O'REGAN J:

You need to stay near the microphone.

WINKELMANN CJ:

Yes, stand by the microphone.

MR L MCKAY:

Sorry, that won't be the last time I make a mistake. If we treat that –

WINKELMANN CJ:

It's all right, we don't mind reminding you.

MR L MCKAY:

If we treat that as being the Frucor New Zealand semi-universe, it's little solar system, I mean it's a very big company Danone, there is an entire mega universe out here that's represented by Frucor. I beg your pardon, by Danone and we've seen a number of those entities referred to in the context of this arrangement. There was a little bit of evidence, indirect evidence, of just how big, right, Danone is and this is a little small bit at the empire, but from the standpoint of this which is Frucor New Zealand, two points, that's our only frame, relevant frame of reference for the purposes of New Zealand tax law because as I'll come to tell you that among the specific provisions that are of relevance that should've been considered by the Court of Appeal, there are a range of can I call them protection measures erected by the New Zealand Parliament by way of transfer pricing, thin capitalisation required independent entity treatment, all of which is intended to protect us from the stratospheric monolithic, for example, Danone empire to make sure that all the economics between that and our little group down here are at arm's length.

Now that means that for the analytical framework we now have to consider, this 204 million that undoubtedly came in, came in the form of 204 million. It didn't come in as 55 million because of the 204 that came in, one can track to the last cent where it went. It went out the bounds or beyond the bounds of New Zealand. It went into the Danone empire. It went back to pay 144 million of the debt facility issued by Danone Finance and as for the other 60, it redeemed some of the establishment equity from DAP. Now, it's perfectly true that to that extent, to that 60 million extent, your Honour, yes, there was in form a circular flow of funds.

WILLIAM YOUNG J:
Well, it's $149 million is the circular flow of funds.

MR L MCKAY:
I missed the last bit, Sir?

WILLIAM YOUNG J:
It says to $149 million?

MR L MCKAY:
No, it's not, Sir, no, because what and if your Honour will go back to the diagram on I think it was page 5.

WILLIAM YOUNG J:
I've got the diagram in front of me.

MR L MCKAY:
You'll see that, and if we just want to treat it as in the simplest possible terms –

WILLIAM YOUNG J:
I understand other money comes in from BNP.

MR L MCKAY:
Yes, that's right. That's where 89 million, I'm sorry, 89 million Singaporean came from and I think that everyone has assumed for the purposes of this case, Sir, that when you add Singaporean 89 which I think is about 87 or 80 something New Zealand and you add it to the 60 that was redeemed by way of cancellation of capital, that's the source, we'll treat that at least analytically as the source of the 149 million DAP paid to Deutsche Bank. Sir, and that, yes, there's circularity as to that amount. I simply with respect adopt the view of Justice Muir in the High Court on that. It also was the view of Justice Harrison in *Alesco New Zealand Ltd v Commissioner of Inland Revenue* [2013] NZCA 40, [2013] 2 NZLR 175, that in form circulatory,

certainly it's relevant. Certainly the eye picks it up. In other words 60 million going out by way of equity redemption, and coming back in as a component of the 149. Yes, I don't move on from that without testing that real transactions being affected underneath it. But Sir here there's no difficulty with that. This was a refinancing. This was an arrangement entered into in part to increase the level of New Zealand dollar denominated debt in the local business. Which it did. It increased it from 50% to 67%. The only way you do that is by redeeming equity and –

WILLIAM YOUNG J:
Sorry, pause there. Is that largely because of the 60 million repayment of capital?

MR L MCKAY:
No, it must be mathematically Sir because 60 million has gone out by way of the repayment of, redemption of capital and it – I'm sorry. Now I see Sir. Yes Sir, it's come in by way of debt. The previous debt level, 144 million, to Danone Finance, comes in by way of, well 204 million from Deutsche Bank. But Sir that's how, I'm sorry, I don't mean to get the tone of this wrong –

WILLIAM YOUNG J:
So $144 million in debt, is that replaced by $89 million in debt?

MR L MCKAY:
No. I think, Sir, the 89 million is the Singaporean part financing of DAP.

WINKELMANN CJ:
How is the equity reduced, how is the equity funding reduced. Can you just restate that for me?

MR L MCKAY:
Yes. There were 1,000 shares worth $150,000 each issued by Danone New Zealand to DAP at the establishment, or as part of the establishment financing. That's where the 150 million equity comes from.

What happens is that 60 million, or 400 of those shares are cancelled, and they're cancelled for their subscription price of $150,000 per share. So 60 million of the 204 million that comes in under the arrangement is applied for the purposes of that equity reduction, and the other 144 million to Danone Finance to repay the debt facility. So because it's a refinancing, it's virtually inevitable that that's going to occur. You're going to reduce equity and increase debt, and as long as the transactions by which that's affected are legally binding transactions, and do affect a genuine change, commercial change –

WINKELMANN CJ:
Well they're not a sham but that doesn't meant that they're not tax avoidance does it?

MR L MCKAY:
Well –

WINKELMANN CJ:
No one's saying they're a sham.

MR L MCKAY:
No, they're certainly not a sham. To be tax avoidance there'd have to, in *Ben Nevis* terms, be beyond parliamentary contemplation with reference to the use of specific provisions which let you redeem equity and take on debt.

WINKELMANN CJ:
So that's at on the day 1 of this transaction. What happens on day, what happens on the maturity day of the convertible note. What's the equity situation then?

MR L MCKAY:
Well on the maturity date of the convertible note there is an additional 254 million in equity in the local business because the note converts into shares, and that – so there's a full stop there.

WINKELMANN CJ:

And what does that do to the debt equity ratio?

MR L MCKAY:

That materially increased the amount or proportion of equity on the local balance sheet. If I might say so, it's confusing because at that same time Danone was negotiating for the sale of the entire New Zealand business to Suntory, which it did subsequently sell later that year, and there was a capital reduction effected by the local business.

WILLIAM YOUNG J:

But the 200 – at maturity date Danone owns still 100% of Frucor?

MR L MCKAY:

I'll check that at the adjournment, but just say yes Sir.

WILLIAM YOUNG J:

Unless – yes.

MR L MCKAY:

I'm sorry, I missed the…

WILLIAM YOUNG J:

But there's no more money in Frucor though is there?

MR L MCKAY:

No there is a very, for what's it's worth, and it's not worth anything analytically for our purposes, there's a very, very significant increase in the enterprise value of the business –

WILLIAM YOUNG J:

But that's unrelated to these transactions –

MR L MCKAY:

– but there is a difference in terms of debt and equity Sir on the basis that while that 204 million sits there under the convertible note, it is, for the purposes of the financial statements, remember I said Frucor New Zealand was in its own little bubble down here, that bubble is also for the purposes of financial accounting and under the Financial Reporting Act 2013 that 204 million sits there as 204 million throughout the period of the issuance of the convertible note because it's a debt liability in the contemplation of the financial standards. Now at the point at which the convertible note matures, and since we know that conversion into shares was elected by Deutsche Bank, well at that point it becomes equity, and that would have been of ongoing significance as I say apart from the fact that, I was going to say an even bigger company, I'm not sure Suntory is, but another very big company came and bought the Frucor New Zealand business from Danone. But there's absolutely no doubt, Sir, it sat there as debt, and it –

WILLIAM YOUNG J:

But given the back to back arrangements that were already in place, nothing really changed on, in substance changed?

MR L MCKAY:

Well one can say, I think I could say that Sir though often with reference to a, can I call it an uncluttered debt equity realignment. 50/50 is a lot of equity, given that New Zealand's thin capitalisation rules at the time permitted 70% of debt for interest deductibility purposes, and to bring the debt equity position into a position where more debt was on the balance sheet, though still within thin capitalisation constraints, is in itself pretty unexceptionable in my respectful submission, certainly in terms of BG 1. No one is going to impose BG 1 because a company chooses to increase the level of its establishment debt capital to something still well short of, but something approaching thin capitalisation guidelines. I beg your pardon. Limits. So if you got it a bit wrong, assuming that is the case, at the outset, you put too much equity in, the way to do it is to redeem the equity and to bring in more debt, and if, as here, these are all related party, until we get to the convertible note, all related

party debt and equity, then the equity is redeemed to a related party. So is the debt repaid when the new debt comes in. I'm sorry.

GLAZEBROOK J:

I just wanted to, just getting it right down to its basics, it seems to me that it's, and I'm not wishing to deter you from the more detailed analysis, but it seems to me to come down to a different view of economic substance. So either this was a loan of 55 million, and the 66 million was a payment of both interest and principal to Deutsche Bank, and that's all this transaction was, and on that basis, which is the Commissioner's view, you don't get a deduction for what is the repayment of principal. Or alternatively in economic substance, it was the provision of 204 million, 55 million from Deutsche Bank and 55 from Danone, by way of debt, in which case the whole of the 66 million is interest and deductible. So it's a straight clash between different views of economic substance, and it might be that you only come to the first view of economic substance if you, as you suggest, ignore some of the specific provisions. But basically that's the difference between the two positions, and the first position has something going for it because, as you said, the interest rate was actually calculated in order to amortize and pay the interest on 55.

MR L MCKAY:

Yes, it was, yes. The other, I'm sorry, I'm not resiling from the general point.

GLAZEBROOK J:

I know you're not. I know you're not trying to slide away from that at all, but I was just putting it down as the two difference, the difference of analysis in terms of economic substance.

MR L MCKAY:

And I will, and in fact, it is probably appropriate that I turn to it now. I mean I –

WINKELMANN CJ:

Well, just before you do, you were partway through telling me the other rules that you say because it's clear that the Court of Appeal had a pretty good idea

about what the phase one for the *Ben Nevis* for the interest deductibility rules, didn't they?

MR L MCKAY:
Yes.

WINKELMANN CJ:
You couldn't say otherwise, but you're saying that they failed.

MR L MCKAY:
I'm sorry, no, please.

WINKELMANN CJ:
You're saying they failed to take into account all the other provisions that Justice Muir took into account.

MR L MCKAY:
Yes.

WINKELMANN CJ:
And you've taken us to the financial arrangements rules, the thin capitalisation rule and is there anything else?

MR L MCKAY:
Yes and that's I've been coming to it on two occasions and I've got myself confused as well as the Court confused. I started, basically that's at paragraph 29 and following on page 9, your Honour, and can I just pause for breath before I turn to that and just say where I think I'm up to. Yes, among, and I've certainly got Justice Glazebrook, her Honour, Justice Glazebrook's dichotomy in mind, where I'm up to is this that notwithstanding with respect, Sir, to his Honour Justice Young's point, the Court of Appeal took into account the specific provisions of relevance by ignoring them. In other words, there's virtually no analysis contained in the Court of Appeal judgments of any of the

rules that I have already hinted at and which I will now go on to try and summarise your Honour.

The Court of Appeal went more or less directly to that what I've set out in paragraph 23 and in paragraph 24 as being its characterisation. The real loan, in Justice Glazebrook's term, their view of the economic substance was that this was a $55 million, effectively a net loan, right, and the rest of it we can somehow treat as being some form of equity subscription. I do say and respectfully that that is wrong.

WINKELMANN CJ:
Or, effectively, an artifice, however you characterise it, an artifice to inflate the amount of the loan which I think is how they regarded it.

MR L MCKAY:
It would, in my respectful submission, then have been helpful as to how the Court of Appeal could have regarded the other steps, those other steps being the reduction of equity capital, real effective binding, not only not a sham effecting a real change in the equity position of the Frucor New Zealand business. The repayment of 144 million debt, and again, not only not a sham, a genuine commercial legal repayment of a de-establishment debt liabilities, okay. The introduction of 204 million onto its balance sheet and the payment of $66 million interest, it's with respect, it will have been helpful for the Court of Appeal to have said why it was that those changes in the company's position were themselves the subject of artifice. Why was it that this is just a net loan and nothing else matters in tax contemplation because those other changes affected real alterations in the position of the company?

WINKELMANN CJ:
Yes, but I think there you're drawing, creating a false dichotomy because the Court of Appeal didn't have to conclude that it was a sham. They just had to say it was a transaction structured with contrivance and artifice with tax avoidance as a non-incidental purpose.

MR L MCKAY:

Yes, and had they gone into some of the specific provisions that are summarised in paragraph 30 of the appellant's written submission they would've seen that that is difficult to do, or a categorisation is difficult to make in terms of any sensible or rational basis for integrating the specific and the general anti-avoidance provision. In other words, I'm saying, your Honour, they can only do so by paying far too little regard to the specific provisions of the legislation that I'll take you to now.

WINKELMANN CJ:

Right.

MR L MCKAY:

And I appreciate the time, your Honour, but I can certainly, I get most of the way through the point. I'm at paragraph 30 of the written submissions.

ELLEN FRANCE J:

Sorry, could I, before you start did you say that the desirability to make the change in the equity position was the sole purpose from a New Zealand perspective?

MR L MCKAY:

No, I may have and I think that was –

ELLEN FRANCE J:

No, no, well, that was why I was checking did you say.

MR L MCKAY:

No, no I did not. I'm certainly saying that was a very genuine consequence, your Honour. There was a realignment of the debt equity ratio in a not immaterial respect, but when we come, and it will be after the adjournment, but another important effect of the arrangement was that there was no, it was called in the papers "income pickup". No tax liability arose in Singapore by DAP on the receipt of the economic gain arising from this arrangement and

that was compared obviously with the position of Danone Finance which was the lender under the establishment structure because it put conventional debt into the New Zealand business, it received conventional rate of interest on that. Certainly that was deductible to the New Zealand business, but it was taxable in France and was subject to withholding tax on the way out of New Zealand whereas under, as a consequence among the other consequences of the refinancing was that what had previously been taxable to the offshore Danone lender became a non-taxable receipt in the hands of DAP because of the Singaporean absence of tax liability on that form of economic gain derived by DAP, but, your Honour, I will come to that in a little bit more detail because that is of significance that consequence is a significance in terms of the subsidiary submission that any tax advantage arising to the parties or to the Danone parties here was merely incidental in terms of that tax avoidance arrangement definition.

I promised on three occasions, can I go now to, briefly to paragraph 30?

WINKELMANN CJ:
Well, it is almost 11.30. Would it be better to start on this or is it a short point?

MR L MCKAY:
It's not a long point but it's not a short one. No, I'm very happy picking up.

COURT ADJOURNS: 11.29 AM

COURT RESUMES: 11.48 AM

MR L MCKAY:
Thank you. I was at paragraph 30 page 9 of the written submission where I list off the variety of specific provisions within the Act which inform Parliament's intent and contemplation with reference to this arrangement and they vary in their character. A number of them, and if I could just recap on a point I made a couple of times in passing before the adjournment, a couple of them, and I'm referring particularly to (c) and (d) establish what I might call the

defence mechanisms that New Zealand places around the New Zealand tax base with reference to particularly debt capital coming in from a non-resident owner of a business. The propositions in (c) and (d), or the matters in (c) and (d) relate only to related parties. They relate to dealings between illustratively the Danone international group and the New Zealand business and I'm referring to them here predominantly for the reason that they do provide safeguards against, for example, an extravagant or an over-extravagant debt capitalisation of the New Zealand business, or an attempt to repatriate profits from New Zealand by using artificial or inflated rates of interest on debt and similar matters. I want to just conclude on that issue by saying, or reiterating, that there is no suggestion at all that the recapitalisation of the Frucor New Zealand business affected by this arrangement in 2003 came even close to offending either of those international or defence net around New Zealand Inc propositions.

The second subset of specific provisions relate, and I'm picking up this at paragraph (e) relate predominantly to the New Zealand financial arrangements rules, or formerly the accrual rules. If we look at those defence mechanisms, the international mechanism, thin capitalisation, transfer pricing and the parallel requirement to treat New Zealand businesses even though wholly owned by offshore people, nevertheless as independent and operating on an arm's length basis in all of their dealings with those non-residents. If we treat those as at a high level attempting to stop the worst examples of inflated transfer pricing or other internationally viewed unacceptable dealings, then they're not of a great deal of benefit, or they're certainly not of full utility unless New Zealand defines with real precision what constitutes a debt instrument because as a general proposition, these international rules, or our international rules, treat debt as being the villain of the piece. Don't have any trouble with equity coming in because equity does not give rise to a New Zealand deduction. It doesn't, therefore, involve a cost to the New Zealand tax base. In fact, we'd love it if people brought 100% equity in on every investment. It's debt that is the policy concern and there isn't any point in erecting a series of barriers that are intended to arm the revenue against misuse or excessive use of debt unless you define what debt is. In

particular, unless you define in the case of say a hybrid instrument like a convertible note whether it's debt or equity, or the extent to which it is debt or equity.

Now, the financial arrangements rules were introduced in 1985 and 1986 and they were precursed by a detailed examination on the part of Parliament and its advisors and its experts of the debt or equity character of the various means of funding a New Zealand business. The policy goal was to determine what the debt was, but in the course of doing that it was as a design and policy matter, it was important that Parliament went through every instrument by which funding could be introduced into the New Zealand tax base by non-resident related parties and say whether for the purposes of New Zealand tax law that was going to be debt or that was going to be equity. Or, if it was both, the extent to which it was going to be debt and the extent to which it was going to be equity.

The result was a highly comprehensive and detailed and difficult series of provisions then called the accrual rules, now called the financial arrangements rules and also a series of, in a sense, subordinate legislation passed under the authority of those financial arrangements rules whereby the Commissioner, as Parliament's delegate exercised a Determination, with a capital D, a Determination making power to take particularly instruments that were difficult, that were on the boundary like a convertible note and determine the extent to which it was debt or equity or determine the extent to which interest payable under it would be debt, or sorry, deductible or would be non-deductible and in the course of those determinations, or by following through those determinations it's possible to gain at least a significant degree of assistance in the enquiry that we're presently confronted with because we are dealing with a convertible note as the instrument under which the 204 million came in. We are dealing with a classic hybrid instrument. We're dealing with an instrument that has both debt and equity features and Parliament, through the Commissioner, through the determination making authority, has looked at either possible description of our current note as either an optional or a mandatory convertible note and has determined in a sense, your Honours, in

a been there done that context for our purposes what its debt and equity character is.

WILLIAM YOUNG J:
That does assume these rules occupy the ground to the exposure of the anti-avoidance rule?

MR L MCKAY:
It certainly isn't the appellant's position, your Honour, that it's impossible, or there's no scope for an overlay of section BG 1 over the top of the financial arrangements rules or the determinations issued pursuant to them.

WILLIAM YOUNG J:
Isn't it, just to put the proposition again I put to you, isn't it the approach of the Court of Appeal in an arguable view that all of this just presupposes in the case of the convertible note an orthodox convertible note rather than a contrived one? I know it's a view which is sort of destructive of some decades in the past of tax planning, but if that view is available, then isn't the Court of Appeal judgment correct, or arguably correct?

MR L MCKAY:
Not in terms of parliamentary intent and contemplation, Sir.

WILLIAM YOUNG J:
Why can't you say the parliamentary purpose of providing these deductibility rules is that they will apply to transactions where their form equates to, or is consistent with their substance and the underlying commercial purposes of the parties?

MR L MCKAY:
I imagine you could, but with respect, Sir, before you would do that in terms of parliamentary intent and contemplation, or under the rubric or that justification you would have to be able to point to an advantage or a benefit that was arising to the issuer of that note to a related party.

WILLIAM YOUNG J:

Well, that's what I guess, that goes to the other question, do you look at this as simply being an advance of $55 million?

MR L MCKAY:

Yes, but even then, your Honour, and I am taking this out of sequence and I'm letting myself move away from paragraph 30, but even in those circumstances wouldn't you have to ask, your Honour, whether there was an advantage or a benefit that was accruing to the New Zealand taxpayer through the issuance –

WILLIAM YOUNG J:

That's getting deductibility for principal repayments.

MR L MCKAY:

But in circumstances where it's in the nature of these financial arrangements rules and the purpose that I've just described –

WILLIAM YOUNG J:

Then we go back in a circle.

MR L MCKAY:

I beg your pardon, Sir?

WILLIAM YOUNG J:

Then we go back in a circle. If you accept the two propositions, these rules are designed and contemplated as being applicable to kosher, orthodox transactions where their form is congruent with their substance and secondly, looking at this in the round, all we've really got is a $55 million loan.

MR L MCKAY:

Sir, I'm sorry, your Honour, I know I'm not putting it correctly. There would have to be two minimum additional conditions you'd have to satisfy with respect before you could adopt that view of it. The first of them is you would have to at the very least give some character to the 149 million that came in.

In other words, if the proposition is what this really is, is 55 million, that's not disputed by the appellant insofar as DB's own, Deutsche Bank's own contribution to it is, but 204 million came in, well, what's the nature of the other 149 million? It certainly is a contribution under the forward purchase agreement by DAP, but what's it's New Zealand tax character? It certainly came to Frucor New Zealand. So, if we can't treat it with respect, Sir, you can't treat as a nothing.

WILLIAM YOUNG J:
You say because BNP put in $89 million you can't say it's simply circular, that the 149 just goes around in a circle and then it gets cancelled out in five years' time by another effectively circular transaction?

MR L MCKAY:
No, I'm certainly not saying that, Sir.

WILLIAM YOUNG J:
No, I know you're not.

MR L MCKAY:
I'm saying that there is no doubt it came in and it used the 204 million.

WILLIAM YOUNG J:
But in reality, BNP can be treated as substituting for DAP Finance. There is a reduction indebtedness of 55 million, of that chunk of investment of 55 million.

MR L MCKAY:
No, there is no reduction. With respect, Sir, there is no reduction in the level of debt in Frucor New Zealand. It's level of debt went up from 144 to 204. There's no reduction in the level of debt at the DAP level. It received 60 million by way of capital redemption but it borrowed 89 million Singaporean from BNP.

WINKELMANN CJ:

Is your argument the Court of Appeal had to come up with the economic substance for the entire transaction?

MR L MCKAY:

Yes, it had to come up. It just can't treat this in circumstances where 204 million comes in, 204 million is used, the document not a sham provides for a 204 million purchase price, I beg your pardon, subscription price for the note, you must characterise the 149 million and the financial arrangements rules do.

WINKELMANN CJ:

But didn't the Court of Appeal characterise it as economically valueless or meaningless capital?

MR L MCKAY:

That's one. On the assumption I have time, which I expect to, I will go through briefly the four reasons advanced by the Court of Appeal for that view. Yes, they did, but they characterised it in a way that had they, with obvious respect to the Court, if they had borne in mind the directions and the provisions within the financial arrangements rules, they would've recognised that there's absolutely no difference in New Zealand tax contemplation between the restructured, the recharacterised arrangement for section BG 1 purposes and the prearrangement tax position here because what the financial arrangements rules do is that they've, and I'm sorry to repeat the phrase, they've already been there and done that even with reference to the Commissioner's recharacterised 149 million which the Court of Appeal agreed with. That recharacterisation, if you will recall, the Commissioner's submission I've summarised at paragraph 23 and then the Court's conclusion at paragraph 24 of the written submission was that there was a packaging together of a 55 million contribution on the part of Deutsche Bank. To get the packaging there's no doubt that 55 million came out of Deutsche Bank's own resources, but it was "packaged together" with a payment by DAP on day 1 for the issuance of shares in five years' time.

WILLIAM YOUNG J:

Can I just ask you, I mean I'm looking at your chart, effectively, $144 million was owed to Danone Finance?

MR L MCKAY:

Yes.

WILLIAM YOUNG J:

One way or another it is replaced by 89 million from BNP Paribas and 55 million from Deutsche Bank?

MR L MCKAY:

Yes. I think with respect, Sir, you're missing the 60 equity.

WILLIAM YOUNG J:

Well, I'm not particularly interested in how these transactions are characterised. There is a flow of funds or an elimination of a debt between Frucor and Danone Finance of 144 million.

MR L MCKAY:

Yeah, yes, there is.

WILLIAM YOUNG J:

That funding effectively is replaced by 89 million from BNP Paribas and 55 million from Deutsche Bank?

MR L MCKAY:

That's one. Yes, I'm sorry, I'm not doubting that it's a debt refinancing, your Honour. There's more debt at the end of it than there was at the start, that's correct though.

WILLIAM YOUNG J:

Well, is there more debt?

MR L MCKAY:
Yes, there's 204.

WILLIAM YOUNG J:
Isn't it the same amount of debt?

MR L MCKAY:
I beg your pardon, Sir.

WILLIAM YOUNG J:
Isn't it the same amount of debt, 144 million? I'm looking at Frucor as a group I guess, but there's $44 million or treating Danone Finance out it I suppose, but there's $144 million in debt that Frucor owes?

MR L MCKAY:
Yes.

WILLIAM YOUNG J:
Before the deal starts?

MR L MCKAY:
Yes.

WILLIAM YOUNG J:
At the end of the deal there's $144 million owed as to 89 million by DAP from BNP and 55 million by Frucor to Deutsche Bank. I mean the figures can't be coincidence.

MR L MCKAY:
Oh, no, the figures aren't coincidence. The critical issue with absolute respect, Sir, the critical issue is that one does not determine the New Zealand tax consequences of transactions entered into by Frucor New Zealand by reference to the international group position.

WILLIAM YOUNG J:

Why not, if it's part of the purpose or arrangement? If the purpose or arrangement incorporates offshore companies, why don't we look at them?

MR L MCKAY:

You can certainly look at the transactions that were taking place.

WILLIAM YOUNG J:

And the purpose?

MR L MCKAY:

Sorry, Sir?

WILLIAM YOUNG J:

And isn't that relevant to the purpose of the transactions?

MR L MCKAY:

The purpose of the transaction from the standpoint of the only taxpayer that matters –

WILLIAM YOUNG J:

Where does that come from? Why can't we look at the purpose of the arrangement as a whole?

MR L MCKAY:

It comes from the proposition that the only income and deductions that are relevant here relate to the position of Frucor New Zealand.

WINKELMANN CJ:

But it's the purpose of Frucor New Zealand, it's the purpose of the arrangement, isn't it?

MR L MCKAY:

Yes, but if as a consequence of the entry into the arrangement, there is a greater level of debt that sits on the Frucor New Zealand balance sheet, then

although there may be other purposes of the arrangement and very clearly there were, the only relevant purpose is the position of the only New Zealand taxpayer that's affected. If the purpose of the –

WINKELMANN CJ:

I don't know where you get that principle in law. The only relevant purpose –

MR L MCKAY:

I'm sorry, your Honour, I don't know how the principle could be any other than that. Let's take the international group position and say that as a result of that –

WINKELMANN CJ:

So, you're saying the only purpose we should have regard to is what Frucor's purpose is, is that what you're saying?

MR L MCKAY:

Frucor New Zealand's purposes. In circumstances where Frucor has got more debt at the end of it than it had at the start, that has to be part of the analytical frame of Frucor.

WINKELMANN CJ:

Don't we get it from the legislation and that's the purpose of the arrangement?

MR L MCKAY:

No, but I would get – yes, the purpose of the arrangement insofar as it has New Zealand tax consequences. The international tax consequences of this were obviously in some senses quite profound. We end up with the Danone Group receiving 55 million economic gain in Singapore in a tax free manner.

WILLIAM YOUNG J:

But it's not really. All it receives, it starts with 100% of Frucor and it ends with 100% of Frucor?

MR L MCKAY:

No, not for the purposes of its financial accounts.

WILLIAM YOUNG J:

Well, yes, I know. I'm looking at it in terms of substance.

MR L MCKAY:

Well, Sir, as a matter of substance I would've thought with respect that the financial statements prepared, at least in the case of New Zealand under the Financial Reporting Act 2013, requiring the signoff of an auditor, given the substance based view of IFRS and the equivalent New Zealand standards, aren't a bad starting point for the two of them in the substance of the matter.

WILLIAM YOUNG J:

Okay, well maybe, maybe.

MR L MCKAY:

But, Sir, from the substance of the matter is that there's a fundamentally different lens if we look at this from a group position relative to a New Zealand position. From a group position, very little change with reference to this arrangement from the standpoint of Danone. I think that was part of the burden of your Honour's comments a moment ago. There's no doubt, for example, that from a whole of group Danone position it's liability arising from the arrangement was a net 55 million and all of the documents that the Court of Appeal went through in really the substantive section of its judgment which was a documentary trawl through DB and to the extent they exist Group Danone documents all showed that Deutsche Bank's exposure under this arrangement was $55 million. They also showed that from a Group Danone perspective, it's liabilities to third parties arising as a result of the arrangement were also $55 million. In other words, in its consolidated international financial accounts it treated the arrangement as involving a $55 million exposure to Deutsche Bank, but the reason for that is that all members of the Danone Group above the little automatic sealed New Zealand business were in a position to varying degrees to consolidate the entities

below them. So, if we take Danone Group right at the top, and this is a matter of evidence in preparing its own published accounts, it had arising from this arrangement, it had both an asset and it had a liability. Its asset was represented by one of its consolidating entities DAP 149 million investment under the forward purchase agreement. Its liability was 204 million which was the amount of the subscription price coming in by way of debt into Frucor New Zealand. When it consolidates, as it is entitled to, the 204 million liability sitting on Frucor New Zealand's balance sheet with the 149 million asset sitting as an asset on DAP's balance sheet obviously it is treated as an exposure external to the group to third parties of 55 million. That's why, if I might say so going back to Justice Young's question, why the international perspective with reference to this arrangement is not the New Zealand perspective with reference to this arrangement. Frucor, for example, cannot consolidate with entities above it. It doesn't own the 149 million asset and it could not, under financial reporting standards, or IFRS, which are the same thing here, could not take the 149 million on its on balance sheet as an asset to give rise to a net liability of only 55 million. The New Zealand perspective is fundamentally different from the international perspective and that's why the thin capitalisation, the transfer pricing, the separate entity treatment between parents and subsidiaries that I've described in brief form in the specific provisions analysis here, are so important, at least –

WINKELMANN CJ:

I was going to say there is nothing. In fact, the law, as explained in *Ben Nevis* requires us to look through corporate forms to group transactions together to try and sense what their true substance and purpose is, isn't it? I mean I know IFRS may not permit Frucor to consolidate itself with its parent companies, but when we look at the true substance and purpose, there is nothing that requires us to just look at Frucor.

MR L MCKAY:

Ben Nevis was a domestic transaction.

WINKELMANN CJ:

That's not so. I mean it brought in all sorts of international parties, didn't it?

WILLIAM YOUNG J:

There were insurance.

MR L MCKAY:

Well, yes.

WILLIAM YOUNG J:

Yes, there were.

MR L MCKAY:

All right, yes. It's fair to say that with all of the tax impact in *Ben Nevis* were New Zealand tax impacts.

WINKELMANN CJ:

But that's you are bringing in different considerations. We're moving all over the place here. I mean isn't it even more remarkable to look through the, these are separate legal entities that sit outside a group in *Ben Nevis* aren't they, these insurance companies?

MR L MCKAY:

I believe that would be so with reference to the insurance entity, yes. I'm sorry, I seemed to haven't answered, or haven't even tried to answer the question, your Honour.

WINKELMANN CJ:

Well, you're saying, I think your point is that the Court of Appeal was wrong to look at the whole group working out what is economically happening from a point of view of substance and I'm saying why can't they because in fact isn't that what's required? I mean it would just be a tax avoiders charter if you could simply defeat the instance of taxation by splitting things up in that way within a group?

MR L MCKAY:

Well, New Zealand has done a very good job in protecting the New Zealand tax base through these various mechanisms to which I've referred, your Honour.

WINKELMANN CJ:

That does not mean that the anti-avoidance provisions do not still continue to apply.

MR L MCKAY:

No, they, in turn, they apply to New Zealand tax impacts, your Honour, yes.

WINKELMANN CJ:

Yes.

MR L MCKAY:

And the only New Zealand tax impacts here were to Frucor New Zealand. The only question here is whether or not Frucor New Zealand borrowed 204 million and paid $66 million interest.

WINKELMANN CJ:

And substance, whether the substance of it was that, not the legal form.

MR L MCKAY:

That's correct. It has to be from a substantive viewpoint, but it's a substantive viewpoint that's, with respect, your Honour, is informed by Parliament's intent and contemplation.

WINKELMANN CJ:

At some point you're going to come onto the other evidence that you have to address which is how the interest rates are calculated to how the note rate is set.

MR L MCKAY:

There is absolutely no doubt about that your Honour. It was calculated, the interest rate here was set by reference to a debt rate that had regard to the credit standings of Frucor New Zealand within a small element of implied parental support. In other words, the debt rate was set at what the rate would likely to have been if Frucor New Zealand was borrowing 204 million on ordinary debt markets and no, I hadn't proposed to come onto –

WINKELMANN CJ:

It all just happened to work out that they repaid $55 million plus interest on that basis.

MR L MCKAY:

No, that was a matter of absolute design. It was from the outset. I intended to acknowledge that in my opening comments, your Honour. It was intended as a matter of design and financial mathematics that the $55 million would be repaid out of the $66 million in interest paid by Frucor New Zealand.

I will just round out if I might the various matters that are summarised in paragraph 30 by way of the specific provisions. I mentioned a short time ago that the financial arrangements rules have a role to play in terms of determining Parliament's contemplation because among other things, and it's a lot of other things, in establishing the debt, sorry, in defining the various debt regimes from a New Zealand perspective in respect of offshore methods of financing, those financial arrangements rules went through instruments, debt instruments, or more or less debt instruments at the margin and determined with reference to them whether or not, or the extent to which they would be treated as debt for New Zealand income tax purposes. I'd also made the point that included within the range of instruments that were considered and regulated for that purpose were convertible notes and I think I had concluded before I diverted myself with the observation that convertible notes, whether they're of a mandatory or an optional form have components or features of both debt and equity and therefore, the characterisation of them was an important element in the design and structure of the rules.

Your Honours, the convertible note determinations that were issued by the Commissioner are of relevance at the specific provision and also in my respectful submission at the intent and contemplation level because they contemplate and regulate precisely the instrument that the Commissioner attempts to reconstruct this arrangement into and precisely the instrument that the Court of Appeal in paragraph 24 of the written submission determined as a matter of substance this arrangement was, and I'm just picking up where I left off in my exchange with his Honour Justice Young.

They contemplate that if someone puts in to a New Zealand business 149 million, to take the current number, they put it in on day one and at the end of a time period, five years, they receive a number of shares in that company, they contemplate how that amount is to be treated over that intervening five years and they contemplate that that amount is to be treated as debt. In our case, therefore, the recharacterised transaction that the Commissioner presses for and the Court of Appeal adopted is one that has the same taxation consequences as the arrangement before the Commissioner's attempt to invoke section BG 1 against it and I will just take you at a high level to the numbers that demonstrate that is the case.

The Commissioner says: "No, it really is a loan of 55 million and 66 million were paid by Frucor." They called it interest, but it was a cash flow of 66 million. Therefore, we will say the deduction to which Frucor New Zealand is entitled is 11 million. It's the difference between the 55 million that came in from Deutsche Bank and the 66 million that went out from Frucor. What do they do then with the other 149, they don't try and attempt to characterise that? But, if one treats that as the Commissioner did and as the Court of Appeal does, as a payment on day one by way of a forward subscription for shares to issue in five years' time, that is a debt of 149 million which will give rise to an interest deduction to Frucor New Zealand of the difference between the 149 million effectively loan into Frucor New Zealand and the 204 million agreed value of the shares at the end of a five year period.

WINKELMANN CJ:

Can you just repeat that last statement, sorry?

MR L MCKAY:

Yes. It's effectively treating the 149 million payment in on day one as a loan or a loan-like instrument in terms of the financial arrangements rules that gives rise to a deduction to the borrower or borrower-like party, Frucor New Zealand, of the difference between the 149 million in and the agreed value, 204 million, of the shares at the end of the five year period.

If we put it in the loan universe if we can and if the financial arrangements rules apply to more than loans, but for an analytical framework and I'm not going to look to my right here, but from an analytical framework it's not bad for the likes of me at least to think of them as loan or loan-like instruments as being instruments which are within the financial arrangements rules. Anything that's brought within the financial arrangements rules that comes in and then a time period passes and then goes out can be treated as a loan-like instrument when it comes in as being an amount that's held by "borrower" for the intervening interval and when it passes out may give rise to income or deductions as a result of that deferral period.

Now, in the present case the analogy is 149 million loan, deferral, use of money costs to the borrower and a greater agreed amount going out. Now, if we put it purely in cash terms and reconfigure the example to make it even easier, 149 million in, four or five year period, 204 million out.

When what goes out at the end of the period of deferral is property rather than cash, there is a reasonably elaborate regime in the financial arrangements rules to determine what the value of the property going out is. So that you can still make the same comparison. You can say what came is virtually always cash. Then there is a deferral period, that's the interest period and then there is what goes out at the end of the period and if there is a difference, as there usually will be and there is here between the amount that goes in on day one and the value of what goes out at the end of year five, that that is the

playground of the financial arrangements rules. That's where they say well, if it's debt or if it's debt-like, if it's one of these things that we have to decreed to be debt for the purpose of these rules, that's going to give rise to an interest deduction to the "borrower" and it's going to give rise to assessable income, at least to a resident lender and that's where the Commissioner's reconstruction and the Court of Appeal's reconstruction overlooks the fact that in accordance with these elements of the financial, or this operation of the financial arrangements rules in addition to the 11 million deduction that the Commissioner's reconstruction entitles Frucor New Zealand to, there is another 55 million representing the difference between the 149 million in and the 204 agreed value out which results in precisely the same level of deductions over that five year period to Frucor New Zealand as arose under the prearrangement position.

GLAZEBROOK J:
How do you deal with *Alesco* in all of this?

MR L MCKAY:
I beg your pardon?

GLAZEBROOK J:
How do you deal with *Alesco*? You'd have to say it was wrongly decided, wouldn't you, on that basis?

MR L MCKAY:
Yes, your Honour, I would say *Alesco* was wrongly decided, but I don't want to add to the burden.

GLAZEBROOK J:
You don't think you need to?

MR L MCKAY:
I don't need to.

GLAZEBROOK J:

Why don't you? Why not?

MR L MCKAY:

I beg your pardon?

GLAZEBROOK J:

Sorry, I think you are going to have to explain why you don't think you need to because I personally would've thought you did need to say *Alesco* was wrong because *Alesco* was dealing with related party convertible notes and just because, well I suppose it's because my economic substance had the two characteristics there rather than a forward purchase characteristic because I would have put the forward purchase characteristic as, in your words, outside of New Zealand and the offshore tax advantage part of it rather than the New Zealand tax advantage part, but if you look at my two characterisations you are going to have to deal with *Alesco* specifically I would've thought. I can understand why you are saying you don't need to deal with it. Now I've talked myself around to seeing why you say you don't have to deal with it.

WINKELMANN CJ:

Justice Glazebrook may understand it but I don't, so perhaps if you could tell us why you don't have to deal with *Alesco*.

MR L MCKAY:

I, like the Commissioner, I had in all the courts prior to this court, I had treated *Alesco* as *Alesco* optional convertible note interest free. I had treated *Alesco* as, his Honour Justice Heath and as their Honours in the Court of Appeal characterised *Alesco* as being in substance an interest free advance and in the Court of Appeal in particular, the Court took the view that having regard to well-established notions of incurred liabilities and the ordinary interpretation as well as the case law interpretation of the concept of expenditure, you did not incur a liability or experience an expenditure in circumstances where you subscribe for an interest free convertible note and I would have to say rightly

or wrongly your Honour, Justice Glazebrook, that's the way in which, certainly from our side, we have seen *Alesco* to this point.

GLAZEBROOK J:

All right, so if I can just make sure I understand accepting the characterisation of *Alesco* is an interest free loan despite the financial arrangements rules treating it as in fact an interest free loan, but then I still don't quite understand why you're now treating the financial arrangements rules as relating to this forward purchase agreement in that case when effectively exactly the same argument can be made that, you know, you might say these are worth 204 but they were already owned 100% anyway, so it's not a third party transaction where the 204 might mean something. It's actually a transaction where you're effectively getting what you had in the first place which I think is the sort of argument that comes back to this 55 million one.

MR L MCKAY:

Yes. Can I deal with the *Alesco* point just very briefly? I've got no detailed submission about it. I indicated how it had been treated previously in this litigation. I declined to answer whether or not I thought it was right. I mean it simply doesn't matter for the purposes of the appellant's submissions before you, your Honour. Certainly it was not argued in *Alesco*, perhaps it should have been that by reference to a day one contribution the passing of a deferral or time value money generating period and the ultimate issuance that argument could have been advanced, but I certainly, in the present case, your Honour, I do make, with respect, I do make that submission. I think that's classic financial arrangement's territory. I do think that is supported by the determinations, one of which at least I was going to take you to, to demonstrate that they are treated as debt instruments upon their receipt by the company, that they do generate an interest deduction entitlement to the borrower, in this case, Frucor New Zealand, and that those deductions that arise from them are entirely consistent with their debt instrument, with their debt character. The only difference here is that there is no explicit coupon interest that has been paid over that period, but that's a commonplace. If the parties put in 149 and agree to pay 204 million in either kind or property at the

end of five years, it again is hard – I'm sorry, Sir, Ma'am, I shouldn't be lecturing, but I think that's hardcore financial arrangement stuff. A deferral period with reference to a debt instrument will lead to an accrual of the interest implicit in the two values in exactly the same way as if it's a coupon bearing, then interest will be paid regularly.

The second proposition I can't help but make is yes, of course, *Alesco* is wrong, your Honour, but I don't need to go there.

WINKELMANN CJ:
Why do you say it's wrong?

MR L MCKAY:
I say it's wrong because applying the determination that was of relevance to the instrument in that case, it was clear the expenditure arose once one had split the instrument as determined by the determination into two. Part of it was equity, part of it was debt and the debt component accrued to its face value over the period of the instrument and Justice O'Regan is sick to hearing me, or doesn't remember, but that was the submission of *Alesco* in the Court of Appeal. But the Court of Appeal said: "No, that's not right, there is no expenditure. There is no real expenditure incurred and it's an interest free advance. We don't give deductions for interest free advance."

Can't say that here. The only advance we are concerned with is the 204 million payment under the convertible note by Deutsche Bank to Frucor New Zealand and it bore interest at $66 million in coupon terms.

ELLEN FRANCE J:
In *Alesco*, the Court says the financial arrangements rules were intended to give effect to the reality of income and expenditure. That is real economic benefits and costs?

MR L MCKAY:
Yes.

ELLEN FRANCE J:

Now, I understand what you say about the facts in that case in terms of real economic benefits et cetera, but do you agree with that proposition so it's intended to give effect to the reality of income and those –

MR L MCKAY:

Yes, unequivocally in this case, but then my frame of reference and I think I haven't persuaded at least all of your Honours to this effect yet, my frame of reference is the position of the New Zealand business. Absolutely accepted that there were other parties, including international parties, to this arrangement, but in terms of its New Zealand tax impact, one cannot give regard to the economic reality of this arrangement to Frucor New Zealand without recognising it was a 204 million subscription, 66 million interest coupon paid and the issuance of shares to discharge the liability. But, yes, the proposition is absolutely accepted, your Honour. Sorry, I have let myself get distracted.

WINKELMANN CJ

Where are we up to in your submissions?

MR L MCKAY:

I beg your pardon?

WINKELMANN CJ:

Where are we up to in your submissions?

MR L MCKAY:

I'm having a look, your Honour. I think we're still on page, can I just have a look at page 10. I think all of those matters that I wanted to describe in one way or the other, your Honour, have been covered.

WINKELMANN CJ:

You've actually done quite a lot, haven't you, because you've also done the group approach?

MR L MCKAY:

Yes I have. Yes, there's a lot of efficiency I can subsequently pick up. The one point I think in the specific provisions, which is that paragraph 30 that I haven't yet dealt with is a point that I think your Honour the Chief Justice foreshadowed and that is the agreed $204 million value. I've referred to that in passing there as part of what's called the lowest price clause for financial arrangement regime instruments but I do have a separate section that I'm coming to on that, so I think that will do for the paragraph 30 material, your Honour.

I make the point, and I can do so very briefly, that if one has regard to the scope of the financial arrangements rules, to the various instruments that fall within them to the convertible notes, those borderline debt and equity matters that fall within them, then the proposition that there is a $66 million deduction, I'm sorry, I'm at page 11, paragraph 31, page 11, paragraph 31. The proposition that there is a full interest deduction of the $66 million amount available to the Frucor New Zealand business with reference to the current arrangement is hardly surprising because the result of the financial arrangements rules and all those other specific provisions that I've referred to providing a framework for the protection of the New Zealand tax base against the misuse of debt instruments, but all of those instruments suggest that the, not the ready availability, the availability of deductions for debt funding in a very, very wide variety of debt-type instruments and what I've done in paragraph 31 and following is I've attempted to apply, particularly from some of those proposition with reference to the financial arrangements rules, what I've done is attempted to give a summary of the various forms of debt funding that would have been available without any possible exception being taken on the basis of section BG 1.

WILLIAM YOUNG J:

Would any of those have enabled $55 million of, just call it advance, to be repaid on a deductible basis?

MR L MCKAY:

There's absolutely no doubt or dispute with the Commissioner's proposition that if 55 million comes in as a loan and is repaid on an amortizing basis by 66 million cash flow to the lender, then that is a deduction of principal.

WILLIAM YOUNG J:

But are any of these alternative hypotheses you've going to come up with that, come up with, do they involve the potential for $55 million worth of advance to be repaid tax deductible?

MR L MCKAY:

No, Sir, because a $55 million advance cannot be repaid tax deductible. If the advance is 55 million –

WILLIAM YOUNG J:

I don't think there's any issue that if Frucor borrowed $204 million for its business purposes it would be entitled to claim interest deductibility on that. That's elementary.

MR L MCKAY:

In that case, I'm sorry, Sir, isn't that game, set and match to me?

WILLIAM YOUNG J:

Well no, because what it's also got, have been able to do is repay $55 million claiming deductibility which wouldn't otherwise be available.

MR L MCKAY:

Can we just adjust the example a bit, Sir, and just say that suppose that there was no Singaporean tax benefit to DAP in receiving property as opposed to interest income, there clearly was but interest income would've been taxable in Singapore. The extra shares were not taxable in Singapore, but suppose there had been an indifference at DAP and DAP had lent 149 million to Frucor and DB New Zealand branch had lent 55 million, now that would be absolutely unexceptionable in terms of section BG 1. There would've been, assuming

interest rates are the same – I'm sorry, assuming interest rates are the same in the rejigged example, there would have been 66 million that would be payable by Frucor on that 204 million liability. It's because it would be incongruous and in my respectful submission hardly contemplated and intended by Parliament in any rational way that because Singapore is, or DAP's contributions came through in terms of an advance subscription for shares as the Commissioner would have it, or as is a matter of actual documents, a forward purchase payment to DB, the funding is still the same if you like as a matter of substance. There's still 149 million in one case directly, in the other case indirectly, coming in from DAP, why would that on any rational interpretation of a view of either the economic or the business substance, or Parliament's intent and contemplation, why in the case I put to your Honour, would it be very clear that $66 million was deductible yet on the basis that the Commissioner has sought to reconstruct and the Court of Appeal has adopted Frucor's –

WILLIAM YOUNG J:
Frucor gets more for its $66 million than it would in your hypothetical examples.

MR L MCKAY:
I'm sorry, I have trouble, it's my hearing.

WILLIAM YOUNG J:
Sorry, Frucor gets more for its $66 million on the facts that happened than in the counterfactuals because as it happened, it got an elimination of a $55 million debt, looking at it in terms of substance. On your hypotheticals, it's just plainly interest.

MR L MCKAY:
No, the debt is the same. I'm contemplating it needs 204 million which is exactly the arrangement and it applies the 204 million to exactly the purposes that it did apply the Deutsche Bank money to. It's just that in my, if I can call it counterfactual, in my rejigged example, we've cut out all the intermediaries

and what we've done is we had had Singapore DAP together with Deutsche Bank debt fund $204 million into Frucor. 149 of the debt funding comes directly as a debt at interest from DAP. 55 million comes in by way of debt funding at interest from Deutsche Bank.

WILLIAM YOUNG J:
What happens at the end of the five year period?

MR L MCKAY:
At the end of the five year period their interest has been discharged on both liabilities and there is the need to repay both the 55 million to Deutsche and the 149 million to DAP.

WILLIAM YOUNG J:
But on the deal that happened, there wasn't the need to repay the 55 million, that's the advantage?

MR L MCKAY:
That's because all of the interest was channelled to one of the lenders leaving the other lender, if we just take the 149 million advance again, must have given an interest holiday to the Frucor New Zealand business and that liability, the interest liability, would have accrued so as to increase the amount of indebtedness from the 149 million that's opposed. I suppose the only purpose, sorry if I haven't satisfied you. Are there further questions on that?

I suppose what I'm saying is that hardcore financial arrangements rules all working within those protection mechanisms, all requiring the transfer price for interest to be market, all requiring that the overall level of debt on the little New Zealand business be within capitalisation, requiring, in the case of DAP as a related party that it transact on broadly market terms and it's saying if the notes bother us, or sorry, if the notes bother the Commissioner, then let's just go right to what is said to be the economic substance of the arrangement which is 149 million is coming from DAP directly. Now, I'm saying if you imagine DAP is acting rationally, every intermediate or ultimate parent prefers

debt, it will put 149 million in by way of debt at a market rate of interest. It will, in order to permit DBNZ to be repaid out of the 66 million aggregate interest, it will give an interest holiday, i.e. in the form of an interest accrual on its own 149 million.

WILLIAM YOUNG J:
So then Frucor, at the end of the five year period, winds up with an interest debt to its parent?

MR L MCKAY:
Sir, and I'm going to take you, and this I'm indebted to this to my friend's expert Professor Choudhry in the High Court hearing and I'm saying, Sir, and I don't mean to be disrespectful, so what. As between a parent and subsidiary, we will remove that debt if we want to as Professor Choudhry says by fresh subscription for equity.

WILLIAM YOUNG J:
Right, I have got a feeling we're sort of going down the rabbit hole here.

MR L MCKAY:
I will take you back.

WILLIAM YOUNG J:
I hope it's not my fault.

MR L MCKAY:
I'm sure, no, it's not that, Sir.

WILLIAM YOUNG J:
I mean why would Frucor lend 149 million – sorry, why would Danone lend $149 million to Frucor capitalising interest effectively and then with a view to the whole thing being written off at the end of it by a capital restructure?

MR L MCKAY:
I'm sorry, Sir, and again with respect, it's not written off. It is capitalised.

WILLIAM YOUNG J:

Yes, I said capitalised.

O'REGAN J:

You need to go back to the microphone.

MR L MCKAY:

I'm sorry, Sir, it's not written off.

WILLIAM YOUNG J:

I know, it's capitalised.

MR L MCKAY:

It's capitalised.

WILLIAM YOUNG J:

Then it's all mopped up with a further issue of capital.

MR L MCKAY:

We're dealing here with parents and subsidiaries. We have got, we have a New Zealand tax regime that knows that as between a parent and 100% subsidiary everything is fungible. Everything depends on the meaning that's debt and equity. Everything depends on which, from the menu of debt and equity or hybrid forms, you want to adopt in terms of how you capitalise. It depends on where you want to pay your tax. It won't be in New Zealand. It may not be anywhere, but in our case it's more likely to be in France and you can go through your, I'm sorry, one can go through one's checklists as a corporate financial engineer and work out with precision where the group's benefit is optimised in terms of debt, equity, hybrids or whatever combination and the difference at a group Danone or adopting the New Zealand perspective, Fonterra in terms of its outward investments, the difference between debt and equity is although in legal terms and in tax terms a very important one, is not a substantive difference once you've complied with your own and any local jurisdictions, thin capitalisation, transfer pricing and separate entity principles and that's why it is, we will go to

Professor Choudhry's example, why it is a real world example in terms of related parties to imagine that debt liabilities can be discharged by the issuance of further equity without that being regarded as either BG 1. We're not dealing here in the realm of unrelated parties and we will see when we get on and possibly it will be the first thing I will deal with after the luncheon adjournment, see when we get onto examine those four features, or four reasons advanced by the Court of Appeal. One of them said it was artificial. Well, yes, as between unrelated parties it's uncommon to use a convertible note between parent and subsidiary. It's unusual to price it in the way that this was priced, but those forms of debt instruments are available for adoption and the other relevant point we will see and again it will be after the adjournment, the other relevant point we will see is that there's no tax advantage to the Frucor New Zealand business arising from the selection of this instrument. As I hope I have at least arguably suggested to Justice Young, there's no tax advantage to Frucor New Zealand here relative to a range of other investment, debt investment options that were available to the parties.

WINKELMANN CJ:

That does raise a question, doesn't it, because your submission entails that there was a tax advantage to the Singaporean company which led to this being structured this way. That's not a tax advantage to the New Zealand company because if they'd structured it all in a different way, they could've delivered the same tax advantage quite legitimately to the New Zealand company, but that's asking us to create a hypothetical which didn't take place because they wanted to deliver a tax advantage to the Singaporean company at the same time as delivering a tax advantage, an equivalent tax advantage to the New Zealand company so they structured it in this way.

MR L MCKAY:

I'm, sorry –

WINKELMANN CJ:

There is a tax advantage to the New Zealand company, isn't there?

MR L MCKAY:

No.

WINKELMANN CJ:

Of having this treated as a loan of 204 million?

MR L MCKAY:

That's what it is, your Honour.

WINKELMANN CJ:

Yes.

MR L MCKAY:

It's 204 million by way of convertible note.

WINKELMANN CJ:

I suppose I haven't probably put the proposition clearly enough.

MR L MCKAY:

It was partly that proposition or what I imagined the proposition was that led me to respectfully comment to Justice Young that why is this different from 149 million coming in from DAP with interest accumulated effectively, or capitalised, and a 55 million from Deutsche Bank? It still brings in the same 204 million. It still leads to 66 million going out and it is solvable, or as a housekeeping matter, at the end of the day between related parties by if they need arises, a capitalisation of the debt it brings in.

WINKELMANN CJ:

The answer to your proposition is that they didn't do that. They did this because they wanted a particular tax advantage they got from this combined transaction.

MR L MCKAY:

In terms of Parliament's intent and contemplation though, with respect, your Honour, it's difficult to see how Parliament would draw a distinction, or

intend to list a distinction at either a first or a second stage *Ben Nevis* enquiry between those two cases. It's hard to see and take the examples further, if in fact having attempting to keep the Singaporean tax advantage that it wanted, or had in mind, if DAP had subscribed 204 million inside Deutsche Bank, if DAP had subscribed 204 million for a convertible note in the New Zealand business, that would've given rise to exactly the same $66 million deduction at the Frucor New Zealand business level and we don't know because there's no evidence on this particular one, but one assumes that under the convertible note applying the same Singaporean tax position that we do know with reference to the forward purchase deed that would have delivered shares to DAP at the end of the five year period and the non-taxable gain would have been derived.

If a direct convertible note, in other words, would lead to the same consequences, one has to ask where is the advantage? There is no advantage to Frucor New Zealand. There is –

WILLIAM YOUNG J:
What was the tax advantage that's referred to in the – don't the planning papers talk about an anticipated tax advantage of 28 million?

MR L MCKAY:
No, they talk about 23 million tax.

WILLIAM YOUNG J:
Sorry, I can't hear.

MR L MCKAY:
I'm sorry, $23 million I believe, I will check the number at the adjournment, 23 million –

O'REGAN J:
I think it was 24 million.

MR L MCKAY:

I'm sorry, perhaps 24 million tax benefit arising, it doesn't specify, and I will take you to the page after the adjournment, no it doesn't specify. It specifies rising from the arrangement not a benefit to Frucor New Zealand, or it's not specified to be a benefit to the offshore counterparty either. But if you think about it, I'm sorry, that's a terrible phrase in this context, where is the benefit arising in this arrangement? Is the benefit arising from deductibility on a borrowing of 204 million or is the benefit because the interest, the gain, the economic return as the lender of that amount is not taxed in their jurisdiction? Okay, most, or sorry, I beg your pardon, many and perhaps that increasingly few as time goes, jurisdictions do not have financial arrangements rules. Many would not treat Singapore, for example, sorry, in Singapore it presumably did not treat from the PWC advice that we know of the receipt of shares as a substitute for interest income as taxable. It certainly wasn't taxable as interest. PWC's advice was that it probably wouldn't even be revenue, probably capital, but you're acquiring shares rather than selling them. The issue will only arise when you sell them.

Now, we're different in that respect. We were particularly different in 2000 because we adopted, as the AHB, the *Auckland Harbour Board* Privy Council decision confirmed, our financial arrangements rules were based on economic and substance approaches. Most jurisdictions didn't work that way, so where's the benefit in Frucor New Zealand getting a $66 million deduction on its 204 million borrowing when juxtaposed with no income or no tax liability on the receipt and all we have to do is think again what was the Danone Finance, the initial cash management facility advantage of 150 million? It gave rise to an interest deduction in New Zealand on the market rate of interest paid and it was taxable in France. So what Danone International has done through this arrangement is that it has avoided or prevented a tax liability on the interest received from the lender from being taxable in the lender's home jurisdiction.

Now that's manifesting an advantage and that way may well be a 23, 24 or 26 million advantage, but it is not an advantage in New Zealand tax contemplation because the interest deduction is the same assuming the

market rate of interest is the same as before the arrangement was entered into.

When I mentioned before that there, and I probably exaggerated and said a universe of debt examples where the same result would follow, I have summarised –

WILLIAM YOUNG J:
Just pause there a moment. Danone gets back, Danone Finance effectively gets back 144 million?

MR L MCKAY:
Yes.

WILLIAM YOUNG J:
So, that's money that it can deploy for other profitable purposes?

MR L MCKAY:
Of course, Sir, yes.

WILLIAM YOUNG J:
So there's no real saving of interest. There's a substitution of interest income for income resulting from other deployments, one would hope?

MR L MCKAY:
Yes. What it's done though, Sir, if you look at it from the point of view of Danone Groupe with an "e" which is the listed French parent, what the group has done, it has –

WILLIAM YOUNG J:
Substituted internal funding of 144 million for external funding of 89 million and 55 million?

MR L MCKAY:

That's correct and as a consequence of that, Sir, it's prevented a French tax, income tax liability arising on the interest that it was receiving under its $144 million advance to Frucor New Zealand. It no longer is receiving that interest. It's no longer therefore paying French tax.

WILLIAM YOUNG J:

But wouldn't one assume that it will do other things with the $144 million?

MR L MCKAY:

Yes.

WILLIAM YOUNG J:

So the interest that it's no longer paying tax on is likely to be replaced by other income which it will have to pay tax on.

MR L MCKAY:

Unless it repays its own. We have to assume, I'm sorry, I have always assumed that Danone Finance was a group financing entity with major borrowing lines from a range of banks. That may or may not be right. If it repays, your Honour, it might repay the lines or the lines of its drawing down to make its $144 million advance. In any event, there may not be additional French assessable income arising.

Your Honour, it's 1 o'clock. I'm going well.

WINKELMANN CJ:

It's 1 o'clock. So, how are you going? So you're up to about paragraph 42 I think, aren't you?

MR L MCKAY:

Yes, but I have dealt with a lot of the material.

WINKELMANN CJ:

So, you will be finished by three?

MR L MCKAY:

I did say initially 3.30-ish.

WINKELMANN CJ:

Okay, all right, well if you finish by 3.30 that's okay.

MR L MCKAY:

I will try and finish before that. It's been very efficient actually foreshadowing some of the argument, some of the matters that are coming up.

WINKELMANN CJ:

All right, thank you. We will take the adjournment.

COURT ADJOURNS: 1.01 PM

COURT RESUMES: 2.19 PM

MR L MCKAY:

Thank you, your Honour. Just immediately prior to the luncheon adjournment I was discussing with your Honours a number of examples and I can recall two of the examples I took to Justice Young in circumstances where subscription for equity were used by the parent, or the group member, who had lent funds into the New Zealand business to subscribe for further capital and permit the repayment of the debt at the local level and just picking up and concluding that element of the submission, the proposition being that it is routine and contemplated by the financial arrangements rules that debt liabilities giving rise to interest deductions in the meantime may be discharged by the payment of money arising from an equity subscription on the part of the parent.

I note in passing though, I won't take you to them, that the optional convertible note and the mandatory convertible note determinations both contemplate that what is unquestionably a debt liability for the period until the note's maturity will be discharged in the case of a mandatory note and may be discharged if an optional convertible note is exercised through the conversion of that instrument into shares. That discharges the debt liability. The capital of the borrower is increased. No doubt interest is deductible during the period prior to maturity notwithstanding that there is no actual cash outlay on the part of the borrowing company to redeem the instrument and I will just leave you with the reference if I might to paragraphs 38 and 39 of the appellant's written submissions in which in the context of a transaction closer to the existing fact situation the Commissioner's, one of the Commissioner's High Court experts Professor Choudhry gave materially that example of a situation whereby a borrowing of $204 million could take place, $66 million interest could be paid on that borrowing over the period of the borrowing and where the liability would be discharged by the issuance of further equity to the parent and the witness' are expert advice or opinion was that you don't need a convertible note to achieve all of the other objectives that were in issue in the present case because it would be a simple matter for a Singaporean parent to guarantee the borrowing of 204 million at 6.5% interest and then pay the bank debt off at the end of the five year period through subscribing for further equity and the appellant here agrees that that is the consequence that would arise under the New Zealand financial arrangements rules. But it's a graphic example, a further example, of a situation in which no question of ongoing interest deductibility arises notwithstanding that in terms of the discharge of the principal obligation that discharge takes place in the form of the issuance of further shares in Professor Choudhry's example, it's an example of a case where there is a further issue to a parent raising those same issues, at least in the interstices of a wholly owned consolidated group. Well, what's the value of extra equity to the parent? None of that matters. What matters from a New Zealand tax standpoint is that the debt liability that is discharged by the New Zealand resident business doesn't, is fully discharged for the purpose of the financial arrangements rules. It doesn't give rise to debt remission income. There's no New Zealand notion that well, because it's a costless

exercise on the part of the subsidiary there's no real discharge of the liability. Debt remission income arises, or in someway there is a prejudicial impact back on the interest deductions that are sought and that combined with the express reference to discharge of debt obligations by share issuance in the Commissioner's determinations in the financial arrangements rules must bring that within the realm where one would say that in every sense that result is intended and contemplated by New Zealand's Parliament. So when we're asking that question with reference to *Ben Nevis*, then here the fact that the convertible note did, in fact, transform or discharge by way of the issuance of shares, is a normative New Zealand taxation consequence.

Taking only 30 seconds to do so, I don't think the number, Justice O'Regan –

WINKELMANN CJ:
Can you just, Mr McKay, you're drifting over to the –

MR L MCKAY:
I'm so sorry.

WINKELMANN CJ:
You're very attracted to this side of the bench I can see.

MR L MCKAY:
Yes, I know, I'm sorry. I won't learn.

GLAZEBROOK J:
We can't have wanderers up and down the stage here unfortunately. We don't have the lapel mics.

MR L MCKAY:
Taking away the only, well I was going to say good habit your Honour, that I'd ever learned as an advocate is to wander. Justice O'Regan, the number is not 26 or 24, apparently it is 21.6, not that that matters, but I will give you a

reference. I'm dealing in the old-fashioned way with its volume of a case on appeal volume 3E tab 112.

GLAZEBROOK J:
Do we need to go to that?

MR L MCKAY:
No, you don't. It's just that I didn't accurately reply to his Honour. I have to say that even though I'm compounding the felony now, there are several numbers that float around because the principal amount of the convertible note varied over the one year evolution of the arrangement itself, but that number, Sir, is 21.6 million, though there might well be other numbers there.

WILLIAM YOUNG J:
Sorry, what page is it, sorry?

MR L MCKAY:
The document, I will give you the reference 305.1157.

WILLIAM YOUNG J:
Oh, right, okay.

MR L MCKAY:
But it is a small matter. At page 14 –

WILLIAM YOUNG J:
What tab, sorry, what tab?

MR L MCKAY:
I'm sorry, Sir, I can't hear.

WILLIAM YOUNG J:
Okay, all right, sorry, I've got it now. An estimated NZD 21.6 million was saved in taxes over the five years as interest expense in blank NZD 66.5

million can be claimed as a deduction. So that's treating, is that 28% of 65 million?

MR L MCKAY:
That will be in New Zealand. I don't know. Yes, it will be the New Zealand tax rate multiplied by the 66 million, Sir.

WILLIAM YOUNG J:
So, that's entirely by referable to the 55 million?

MR L MCKAY:
You'd only make that calculation as an economic matter in the circumstances.

WILLIAM YOUNG J:
Sorry?

MR L MCKAY:
You can only make that calculation as an economic matter in circumstances where there is no income tax liability on its receipt, Sir.

WILLIAM YOUNG J:
Sorry, what I was interested in before lunch was how was this figure calculated. It's not calculated on a saving of tax?

GLAZEBROOK J:
I'm not sure I can find the 21 –

WILLIAM YOUNG J:
Page 1157, 305.1157.

GLAZEBROOK J:
But it's not tab 112, it's something else.

WILLIAM YOUNG J:
No, it is tab 112, but it's into the –

GLAZEBROOK J:

Quite a way down, okay.

MR L MCKAY:

Yes, it's exactly half way down: "Tax savings over five years."

WILLIAM YOUNG J:

But that must be, that's a reference to tax saved by Frucor?

MR L MCKAY:

It's tax saved by Frucor in the context where there's no income tax liability out the other side. You'd never make that calculation with reference to interest paid on the Danone Finance facility because there would be a benefit of a New Zealand tax deduction calculated at the New Zealand income tax rate and there would be the cost of the receipt of that interest income calculated at the French tax rate on the other side. There's only one side here because Singapore doesn't tax the economic gain.

WILLIAM YOUNG J:

What's the counterfactual for the 21 million saving? That is that it's just a straight $55 million loan?

MR L MCKAY:

No, it's a tax – no, it's not, Sir, it's a tax deduction for the 66 million.

WILLIAM YOUNG J:

Yeah, I know, but it's a saving against what?

MR L MCKAY:

A saving against a commensurate income tax liability in the recipient jurisdiction.

WILLIAM YOUNG J:

I don't think it means that at all.

MR L MCKAY:

Well, that is what it is, Sir, because that's what the Danone Finance counterfactual is.

GLAZEBROOK J:

Did anyone say anything about this evidence?

MR L MCKAY:

I beg your pardon, your Honour?

GLAZEBROOK J:

What was said about this in evidence?

MR L MCKAY:

It was said by Mr Marcello, and I will ask my friend to give me, I think it's volume 1 of the case on appeal referring to the $1.8 million fee that was paid to Deutsche Bank structured capital markets for its involvement in this transaction and my friend will find the appropriate bit of Mr Marcello's evidence.

WILLIAM YOUNG J:

My mental arithmetic is not quite what it was but I think 21.5 is probably 28% of 66.5, isn't it?

MR L MCKAY:

I am sure your mental arithmetic is a lot better than mine is now. Yes, I accept that, Sir. It will be the tax effect of the New Zealand tax deduction.

WILLIAM YOUNG J:

But it must be referable to a savings of tax in New Zealand, isn't it?

MR L MCKAY:

It will be a savings of tax in New Zealand in circumstances where there's no commensurate tax cost in another jurisdiction because if we assume for a moment that the tax rates were the same in both jurisdictions say as in the

prearrangement position involving Danone Finance, then no tax benefit calculation is going to arise in giving New Zealand interest deductibility.

WILLIAM YOUNG J:
Aren't they paying this money to –

WINKELMANN CJ:
Go forward to the microphone.

WILLIAM YOUNG J:
Sorry, aren't they paying this money to Deutsche Bank in New Zealand?

MR L MCKAY:
They're paying this to Deutsche Bank in New Zealand, yes, Sir. That's the recipient of the interest.

WILLIAM YOUNG J:
But it's recording it as capital and interest, isn't it?

MR L MCKAY:
No, it's not recorded as capital and interest. Certainly in the financial accounts of Deutsche Bank New Zealand, because they're the financial accounts of the Deutsche Bank because that's only a branch, the net exposure to Danone, and this is not Frucor New Zealand but Danone Group, is 55 million and that's absolutely right. For tax purposes, however, and it's my friend's submission that he will present to you this afternoon and tomorrow, the Deutsche Bank New Zealand position was as follows. It took $66 million that it received, that's the amount of interest from Frucor New Zealand, it took the 66 million as interest income and returned it as interest income in that gross amount, but then showing the pervasiveness of the financial arrangements rules, it tax characterised its forward purchase deed receipt from DAP, the 149 million, it characterised that as effectively a financial arrangement involving the receipt by it, Deutsche Bank, on day one of 149 million and the accrual over the five year period of the arrangement of

a liability to DAP on maturity of 204 million and that's the way the financial arrangements rules work. Day one, 149 million, five year period deferral, consideration valued at 204 million.

WILLIAM YOUNG J:
What taxable income is Deutsche Bank in New Zealand –

MR L MCKAY:
Deutsche Bank's net taxable income after taking a $55 million offset against the $66 million interest income that it received was on a 11 million which is a perfectly –

WILLIAM YOUNG J:
That's what I rather thought.

MR L MCKAY:
I beg your pardon?

WILLIAM YOUNG J:
That's what I rather thought it would be.

MR L MCKAY:
Yes, I can't imagine Deutsche Bank entering into it if it was going to have a tax liability higher than its net economic gain on the transaction, but it's not insignificant to us, your Honour, particularly given the issues before us in terms of whether the Court of Appeal got it right in terms of its first stage analysis and integrated that within its second stage analysis. It's not irrelevant to us that this party to a so-called void arrangement that's Deutsche Bank New Zealand is returning in exactly the same way as the forward purchase day one payment accrual of a deduction over the five year period and then a net deduction of 55 million against its assessable income. It's precisely, I'm sorry, whoops, enthusiasm.

WILLIAM YOUNG J:

Well, isn't it just a long way?

MR L MCKAY:

It's precisely the tax position that Frucor adopts here.

WILLIAM YOUNG J:

Isn't it just the long way of saying that Deutsche Bank treated on revenue account $11 million whereas Frucor put on revenue account $66 million and there is an incongruity there?

MR L MCKAY:

Not at all with respect because Deutsche Bank's contribution to its 204 million loan was a net 55. That was its financial exposure to parties external to Danone, but its advance, its loan itself was 204 million. It had to return $66 million as assessable income because that's what the interest on that loan amounted to.

WILLIAM YOUNG J

It took an offset of 55 million?

MR L MCKAY:

Yes, it was certainly an offset. It's an offset, Sir, in the same way as if a bank lends 204 million and in fact participates or sub-participates other lenders to it in order to aggregate the 204 million.

GLAZEBROOK J:

What you're really saying is that it borrowed 149 million effectively from Danone Group. It could've been from a third party?

MR L MCKAY:

Yes.

GLAZEBROOK J:

And its tax position would be it would take a tax deduction for whatever the interest component it paid to the third party is and it would land up only paying tax on whatever it provided internally.

MR L MCKAY:

Yes, if it borrows 149 million from Danone or a bank, adds 55 million of its own, makes an advance of 204 million, it's going to be taxable on all of the interest and it's going to get an offset or a deduction for its own borrowing costs and yes, your Honour, the 149 million that came in –

GLAZEBROOK J:

And it would have to do that else it would be, because you do it on a gross assessible income and gross deductions, you don't do the net?

MR L MCKAY:

No.

GLAZEBROOK J:

And that's been made absolutely clear now in the new way the Tax Act is written?

MR L MCKAY:

Yes, Deutsche Bank, could not return. Yes.

GLAZEBROOK J:

Beforehand you actually didn't know that was the case but now you definitely do, you take gross.

MR L MCKAY:

You could possibly net in the bad old, but the Act has moved as your Honour indicated to a gross basis so you must return 66 million and you get a deduction for your own borrowing cost. But that again, I'm sorry to stress the point, that's also hardcore financial arrangements rules. That's the treatment

the financial arrangements rules require. I'm not making too much of it I hope but it's a little bit incongruous that exactly the same method of calculating the net tax position on the part of Deutsche Bank New Zealand which is to employ as it has to the financial arrangements rules to generate for itself a 55 million deduction for its borrowing cost is the very thing that the Commissioner denies that Frucor New Zealand can do when in response to what I have called my fallback argument which was okay. Well, let's skip the conduit stuff. Let's have DAP bringing 149 million directly by way of a convertible note subscription into the local business. We don't need Deutsche Bank to give rise to the 55 million deduction which when aggregated with the 11 million deduction to Deutsche Bank on its 55 million contribution justifies and requires a deduction for the full 66 million.

WINKELMANN CJ:
So, I'm just conscious of the time and I think you need to get onto the critiquing Court of Appeal's reasoning.

MR L MCKAY:
Yes, and I can do that quite quickly and I will stick very much to the written submission and only summarise it. I think, your Honour, a lot of these points have actually been covered in discussion with the Court this morning. I am starting on paragraph 14. I can immediately move over to paragraph 15. Paragraph 14 I have simply, I beg your pardon, page 14, I have simply reiterated Frucor New Zealand's submission that the Court of Appeal adopted effectively an ultimate question enquiry without in fact going through and seeing what facts and features and attributes from the very extensive specific regime were available to inform Parliament's intent and contemplation.

With reference to the second critique of the Court of Appeal's decision, that's on page 15 and this is something we have already covered to a very large extent, your Honours, the questions of artificiality and contrivance. Yes, judged by reference to an unrelated third party convertible note there were unorthodox or contrived features in this note. One of those contrived features, and there was no resistance to any of this on the part of Frucor in earlier

stages of litigation. It was unusual to use a convertible note when in circumstances where the holder of that note, and that's Deutsche Bank New Zealand, had no intention, no wish to hold the shares into which conversion occurred but had presold those shares to another party, particularly to the parent company.

Yes, that is not a conventional use of a convertible note, but one's entitled to ask the question then: "Well, what New Zealand tax consequences would be any different from the use of that if it's contrived, that contrived structure, relative to the range of ways in which the Danone Group had and could've continued to fund the Frucor New Zealand business albeit with an enhanced level of debt as it was entitled to have." And I have put to your Honours any number of examples where those New Zealand tax consequences, $66m deductible over the five year period would have been the same, including the one we have most recently discussed which was a direct subscription for a convertible note on the part of the parent. But they range all the way from a direct loan from DAP. They include the most obvious if it wasn't for Singaporean benefits expedience of just simply increasing Danone Finance's loan into the Frucor New Zealand business 204 million. That would have achieved the requisite capitalisation, debt capitalisation, level for Frucor New Zealand.

There are no different New Zealand tax consequences arising from the arrangement and certainly it's the case that if it is artificial, it's not leading to any additional tax benefit. If it's artificial, it's because the economic return to DAP in this case gave rise to a Singaporean tax benefit of non-assessability on that economic gain.

On page 16 of the submission and under the general heading "Tax benefits conferred by the arrangement", I can deal with that briefly. That is effectively the same point that I have just made.

The Court of Appeal declined to categorise the Singaporean tax benefit as being a benefit, or at least a benefit as great as the New Zealand tax benefit.

They said it was always just a condition precedent of the arrangement design that the holder of the shares, the party to the forward purchase agreement would be situated or resident in a jurisdiction where there was no tax liability on the receipt of additional shares in the company as opposed to a tax liability on the receipt of cash interest.

Again, as I say, or as we say in paragraph 56 of the written submission, that that is hard to gel with the notion that none of the so-called contrived or artificial features relating to the arrangement or attending the forward purchase or the note would have been necessary to achieve a New Zealand tax deduction for 66 million. That was the given. If you like, that's the condition precedent but we're not disturbing our own ongoing deductibility position. What we have to find in terms of the condition precedent is a jurisdiction, or what we have to find is a jurisdiction that doesn't tax the economic gain. That's where our tax benefit arises and I can't do it now, but I will prior to my reply tomorrow give you the statutory reference, I beg your pardon, to the case book reference to the evidence of Mr Marcello where that point is detailed.

Your Honours, moving on, on page 18 to that round of respectful criticism of the Court of Appeal's approach which I have summarised as a subjective tax influence and a group approach. I can forget the, or not comment in detail upon the subjective tax influence. The Court of Appeal did not like this arrangement. Obviously didn't fancy some of the descriptions of it in the promotional documentation, efficient tax structuring, generic product, and the like, but I can put those to one side.

The point under this heading that I want to focus on is the question of a group approach. The Commissioner's experts in the High Court adopted a group approach. They adopted the position of the Danone entity in general terms. They took the view, at least one of them, for example, that even if the convertible note had been cash converted, you will recall that there were those second and third options involving cash reversion, they weren't likely to arise, but they might have arisen and they did arise as a matter of

documentation, took the view that even in those circumstances there would be no economic cost through the payment of cash by the New Zealand business on the basis that well, it went in one pocket of the Danone enterprise, or went out of one pocket, that's Danone New Zealand, and went into another one, so on a group basis there was no economic cost even on cash conversion.

They also, and the Commissioner's submission adopted a group approach to arrive at the $55 million net loan characterisation for the purposes of identifying the level of the New Zealand business's debt funding. It's absolutely true, as I said, and I'm not going to repeat it in that much detail, as I said this morning, your Honours, that on a consolidated group basis Danone Group borrowed $55 million from Deutsche Bank and there were the other external liabilities and assets that his Honour Justice Young referred to earlier. But on a net basis, the principal impact outside the group for Danone Group was an additional liability of $55 million, but that is on a consolidated financial statement basis of calculation and, as I said, it is because Danone Group as a consolidated empire, is required under IFRS to offset its assets arising from one transaction with its liabilities arising from it and Danone Group has an asset, through DAP it has an asset represented by its $149 million investment in the forward purchase agreement.

So none of that is in any doubt, but it is the case in Frucor New Zealand's respectful submission that none of that group analysis applies with reference to Frucor New Zealand and I've already indicated and I may go back to it on reply if I have time, I've already indicated that for the purposes of New Zealand's statutory financial accounting Frucor New Zealand can't go along and say: "I've got an asset of 149 million, or my group's got an asset of 149 million." It would be self-evident without more in breach of its reporting obligations because it doesn't hold the 149 million asset. All it has got is the 204 million liability.

The last point I want to make on all this –

WINKELMANN CJ:

Can I just you a question about the approach the Court of Appeal took to finding that this scheme had as a purpose tax avoidance? It looked at the memoranda from Deutsche Bank and also from PricewaterhouseCoopers and others to see that there was a tax focus?

MR L MCKAY:

Yes.

WINKELMANN CJ:

A tax focus and an intention to structure the transaction to avoid the incidence of taxation. I contrast that with the *Alesco* decision where the Court of Appeal said, oh, you just have to look at the transactional documents themselves to see objectively the purpose of this scheme is tax avoidance.

MR L MCKAY:

Yes.

WINKELMANN CJ:

So, what do you say about those two different approaches between those two different Court of Appeal decisions?

MR L MCKAY:

I grumble about the approach of the Court of Appeal in this case apparently being influenced by those negative characterisations from the documents at paragraph –

WINKELMANN CJ:

Is there any reason why one shouldn't have regard to that though? I mean, is there any reason why if it's plain from the documents that the purpose of the scheme is in fact to avoid taxation, why the Court shouldn't have regard to that?

MR L MCKAY:

No, as long as the Court does, with respect, the Court of Appeal here did not do and pay very careful attention to two things. Where is the tax being avoided? In other words, just because one of the New Zealand parties to the transaction, one of the parties to the transaction is a New Zealand company, does that mean it's New Zealand tax that's being avoided as opposed to the absence of any income tax liability on an economic gain approximating interest in another jurisdiction, is the first thing I think it has to do and the second thing it has to do is to ensure that notwithstanding the fact that there is a tax focus and even a tax minimisation tone to the actual documents it's looking at, but nevertheless this isn't just a merchant banker selling a corporate treasury, an arrangement and saying: "Boy are there really tax benefits to be derived from this." You still must ultimately ask would those be, are they legitimate tax benefits? Do they cross the line in terms of *Ben Nevis*?

WILLIAM YOUNG J:

That's a slightly different point.

MR L MCKAY:

Sorry, Sir.

WILLIAM YOUNG J:

I mean here's a whole lot of –

MR L MCKAY:

No, I said, I'm sorry, Sir, I said they were different points.

WILLIAM YOUNG J:

Because are you really saying that one can't have regard to what we might call design documents in terms of determining what the purpose of the arrangement is?

MR L MCKAY:

I'm sorry, Sir, appreciate the position I'm in. I can't do more than –

GLAZEBROOK J:

You said you can take them into account but you've got to, first of all, pay attention where they're avoiding tax. So if they say: "This is a major fantastic tax deal," you've got to see whether they're avoiding tax in New Zealand or offshore and then secondly, you've got to say: "Yes, they think they're avoiding tax." Whether it's a legitimate avoiding, well minimising of, and I hate using those words because they've got all of that connotation of some of the matters that were got rid of in *Ben Nevis*.

WINKELMANN CJ:

Because it's meaningless, isn't it, to talk about purpose of it's an artificiality I think that you can't stand to talk about the purpose of documents or a scheme without having regard to what the purpose of those put together is.

MR L MCKAY:

Yes. Why I used the language previously in introducing this section, the language of grumble, is that as counsel my friend and I can only deal with what we're given by the Courts and it is very fair to say, and I think from both our perspectives, that the Courts have not, over time, been particularly consistent in terms of can I call it the significance of inferences from design or promotion documents and the role that they might play.

WINKELMANN CJ:

Yes, it might be better put that the Court's won't be particularly interested in parties getting into the witness box and saying: "Oh, look, it wasn't my purpose to avoid taxation," because that evidence has absolutely no value. It's quite comparable to contract interpretation in that regard.

MR L MCKAY:

Yes, yes.

WINKELMANN CJ:

But where you've got contemporaneous documents from people seeing it who say: "Well, this isn't how we normally do and it's a very complex transaction

but really we're doing this way in order to make sure that we don't pay taxation tax." That might be something you take into account.

MR L MCKAY:
Yes, the cogency and the weight that one would attach to documents that might go all the way along that spectrum you've described, your Honour, that weight will be different I imagine. I still say a little bit grumblingly that it's not clear the directions one gets from the cases, including I might respectfully say so appellate cases on this matter on the significance of these documents is a little bit hazy, but I'm happy to rest with –

GLAZEBROOK J:
So you'd accept that they can be taken into account, but they're just part of the matrix that you're looking at when the Court is assessing what the purpose of the arrangement is, is that, have I put that?

MR L MCKAY:
Yes, that would be carrying on her Honour's contractual analogy in the matter of facts analogy, yes your Honour.

WILLIAM YOUNG J:
What about the fact that Deutsche Bank's profit was in the form of a fee rather than a cost of providing finance or a return on finance advanced?

MR L MCKAY:
That's Deutsche Bank New Zealand, that's absolutely right. One imagines that the treasury operation which funded the Deutsche Bank's own contribution of 55 million would not have, because it didn't get a fee, it would've made a margin on its own borrowing on lending costs.

WILLIAM YOUNG J:
But it does look a bit like a fee for an off the shelf tax scheme?

MR L MCKAY:

No. It looks like a fee for delivering to the New Zealand business a continuation of its interests deductibility position. At the same time it's delivering to the group.

WILLIAM YOUNG J:

Sorry, a continuation of what?

MR L MCKAY:

Of its prearrangement interest deductibility position at the same time as delivering to the group the benefit of no taxation liability to the group recipient of the economic gain on the lending.

O'REGAN J:

Just looking at your, on page 18, that's where the $24 million figure came from?

MR L MCKAY:

Yes, I saw that and that's why –

O'REGAN J:

61(e).

MR L MCKAY:

Yes and I saw that.

O'REGAN J:

It's quoting the Court of Appeal so maybe it's not your figure, it's their figure.

MR L MCKAY:

Yes. It's somewhere in the range of 21–26 million. It's a chunky number, there's no doubt of that, Sir, but whatever the number is, it arises because there's a deduction in New Zealand and there is no income pickup in the foreign jurisdiction. Perhaps I won't, your Honour, Justice O'Regan, perhaps I

won't go back to it in my closing tomorrow, in my reply tomorrow. The last point, I'm sorry, shall I keep moving?

WINKELMANN CJ:
Yes.

MR L MCKAY:
The last point I want to make with reference to this group analysis of the Court of Appeal, this erroneous group analysis of the Court of Appeal, is summarised at the foot of paragraph 70 on page 21 of the written submission and that's that for all that, the big people in town, that's Deutsche Bank and Danone Group, for all they analysed the transaction throughout in terms of the net exposure of Danone Group and the net borrowing need from Deutsche Bank New Zealand, there isn't a single document that refers to the position of the Frucor New Zealand business for the purposes of the statement of its liabilities that does other than treat the borrowing as 204 million and the interest cost as 66 million. And, his Honour accepted a table that was prepared by the then plaintiffs in the High Court that took as far as was known every reference in every document, whether it Deutsche Bank or Danone, and examined whether they were talking about the position of the New Zealand entity or talking about the group position from Deutsche Bank or Danone standpoint and the result of that, as accepted by his Honour, is summarised in the penultimate paragraph, penultimate sentence of paragraph 70.

Your Honours, the submission moves on, on its page 22 to address the issue that we have previously, sorry, that I have previously made submissions on and your Honours have put questions to me with reference to and that is what is termed here the fallback argument of the appellant, the argument that even on the Commissioner's characterisation, that's BG 1 characterisation of this arrangement, then Frucor New Zealand is still entitled to $66 million in deductions and your Honours will recall the characterisation of the Commissioner and the Court of Appeal is that this is an arrangement where Deutsche Bank New Zealand acted as a conduit for $149 million paid by DAP

which are “bundled” together with its own $55 million to form $204 million advance under the convertible note.

Right under the Commissioner’s BG 1 recharacterisation it’s a loan of 55 million from Deutsche Bank. That gives rise to 11 million interest and it’s a payment on day one for delivery of shares in five years. That gives rise to an accrual deduction under the financial arrangements rules of the difference between the 149 and the agreed value of 204 million of the property which will transfer at the end of the arrangement.

Your Honours, the Court of Appeal heard submissions obviously on that fallback argument and the only response to it, or I think it’s the only response to it, appearing in the Court of Appeal’s judgment is in the passage from their judgment appearing at the bottom of page 22 and the top of page 23 and they said, and this is taken from their paragraph 97: “The difficulty with this proposition is that the figure of 204,421,565,” that’s the agreed value sometimes called the lowest price clause that would have been entered into between the parties on the receipt of 149 million, “the difficulty with this proposition is that that figure was an artificially contrived figure and had nothing to do with the value of the shares. The capital requirement was 147 million plus the fee. That was the amount DAP subscribed to the additional non-voting shares. These additional shares conferred no additional voting rights on DAP and their value to DAP would not grow over the five year period. In reality, these shares had no value to DAP as the 100% parent so long as they did not end up with a third party. The funding arrangement was designed to ensure that that would not happen.” I comment in paragraph 78 of the written submission that that approach, and again with appropriate respect to the Court of Appeal, involves a subversion of the particular rules which inform Parliament’s intention and on this occasion what it’s doing is criticising the use of what is called a lowest price clause which is central to and perfectly conventional with reference to the operation of the financial arrangements rules. It just simply isn’t open, with respect, to say, oh, they had no value, they wouldn’t grow over the five year period, no value as long as they didn’t end up with a third party and so on.

The clause that one has in mind that the Court of Appeal is contemplating is the very clause that appeared in the forward purchase deed between DAP and Deutsche Bank.

GLAZEBROOK J:
Whereabouts is that in the forward purchase agreement?

MR L MCKAY:
I'm sorry, I'm simply quoting from paragraph 77 which is the Court of Appeal judgment.

GLAZEBROOK J:
No, no, sorry, I was wanting to know where it was in the forward purchase deed?

MR L MCKAY:
Are we talking about the lowest price clause that was actually used by – I'm sorry.

GLAZEBROOK J:
If you just give me the clause number?

MR L MCKAY:
Yes. I took you to the document this morning, your Honours. It is the forward purchase deed.

GLAZEBROOK J:
I'm sorry, I just want to know what clause number it is.

MR L MCKAY:
Oh, it's not actually a clause number, your Honour, because it is referred to as a condition precedent in terms, in clause 2. It's a condition precedent that the parties execute the letter in the form set out in schedule 1. So, it's schedule 1

that contains the lowest price clause, your Honour, in terms of the forward purchase deed. Has your Honour got schedule 1?

GLAZEBROOK J:
Yes, okay, thank you.

MR L MCKAY:
Page 16 I thought. Yes, 16.

GLAZEBROOK J:
That's all I wanted to know.

MR L MCKAY:
Yes, it's there and it's a conventional lowest price clause. It refers to the body of the agreement and the obligations accepted by the parties pursuant to that and it simply says: "For the purposes of section EH 48(3)(a) of the New Zealand Income Tax Act 1994 the relevant amount is 204,421,565." And what we're doing is presupposing in the context of the fallback argument of the appellant that there's a similar lowest price clause contained within the recharacterised arrangement of a day one subscription by DAP for shares with an agreed value of that 204 million at the end of five years and I've already indicated through the quotation in my paragraph 77 the Commissioner's various criticisms of that clause.

Your Honours, the background to the lowest price clause and its central role in financial arrangements relating to property is set out, and I know time is going and I'm fully sensitive of the fact your Honour and that doesn't matter, I will take you to the appropriate provision that determines, here we are. I think the most convenient point and I've got noted here is the Commissioner's bundle of further authorities tab 1 and the Commissioner helpfully here does what the appellant did not do in its own authorities and that is to provide a comprehensive statement of the financial arrangements rules.

Your Honours, under tab 1, if your Honours will go to about it's three pages from the back and the paragraph numbers are far from intelligible because this is in fact, the last three pages are in fact a different series of statutory amendments to the core financial arrangements rules. I'm looking at page 577, three lines from the back of tab 1. I beg your pardon, four pages from the back of tab 1 and I'm looking at the heading at the middle of the page –

WINKELMANN CJ:
Where are we again, sorry, I've lost that too.

GLAZEBROOK J:
Yes, I'm totally lost.

MR L MCKAY:
I'm sorry, it's probably my fault for referring to tabs rather than document numbers.

WILLIAM YOUNG J:
I thought tab 1 was asset management liabilities.

WINKELMANN CJ:
I thought tab 1 was BG 1.

MR L MCKAY:
I'm in the Commissioner's bundle of further authorities.

WINKELMANN CJ:
Oh, further authorities, okay.

WILLIAM YOUNG J:
Isn't tab 1 of that the Court of Appeal judgment on asset management?

MR L MCKAY:
No, not the Commissioner's bundle of further authorities, Sir.

O'REGAN J:

It's a supplementary bundle as opposed to a further bundle.

ELLEN FRANCE J:

And what's the provision that we're looking for?

MR L MCKAY:

I'm looking on the left-hand side of the page, the page being 577, E8, I beg your pardon, EH 48 consideration.

GLAZEBROOK J:

So it's Commissioner's –

WINKELMANN CJ:

Commissioner's further.

GLAZEBROOK J:

It's really annoying this.

WINKELMANN CJ:

Commissioner's bundle of further authorities?

MR L MCKAY:

Yes. Four pages from the back of the tab page 577 EH 48 consideration.

GLAZEBROOK J:

I don't seem to have them here.

MR L MCKAY:

And these provisions were introduced to make clear what happens in circumstances where a debt liability.

WINKELMANN CJ:

What section are you going for, because in fact my computer is not hyperlinked and it's better if we just go to the external authorities.

ELLEN FRANCE J:

I can't even find them.

WINKELMANN CJ:

I have it.

MR L MCKAY:

In that case, having verified some words exist in the statute, can I speak to it?

WINKELMANN CJ:

Yes, go ahead and do that.

MR L MCKAY:

It was necessary as a matter just of tension issues, as they always arise because these financial arrangements rules are very, very important in practice, important to clarify what happened when money went in on day one in debt form in circumstances where the debt would be discharged at a further period of time after a period of deferral and therefore after a period where interest was likely to arise but discharged by the transfer of property to the debtor and the reformulation of the rules that took place in 1999 and which are set out under that consideration heading say effectively what one does in those circumstances when you've got an agreement for sale and purchase of property. You go through the various heads in subsection (3) of the provision sequentially until you find the one that determines in your case. The first of them is the value of the property or services. So, in other words, it's what goes out the other end which one is going to compare with the amount of income or money that comes in and one's going to say: "Well, that's the measure of income or expenditure."

The value of the property or services going out is the lowest price determined under section OB 7. I'm sorry, is the lowest price the parties would have agreed on the date the agreement was entered into if payment was required in full at the time the first right in the contracted property was transferred or the services provided.

Now, as we apply that to the assumed lowest price clause arising in respect of the Commissioner's reconfigured arrangement, reconstructed arrangement of 149 million in on day one from DAP and the passage of the shares out the other end at the end of five years is we ask first, okay, when does the first right in the shares pass? Well, the first right in the shares here is a matter of the contract. It passed at the end of year five. So we then ask, having got that temporal reference point, all right, what is the lowest price that the parties would have agreed upon for the transfer of those shares at that point of property first passing? And what these parties have done, what we have to assume the parties have done because this is all a reconstructed arrangement as the Commissioner would see it, we have to say well, they would have agreed on 204 million as well for a number of reasons, all of which have integrity, all of which have sense, all of which are entirely consistent.

WILLIAM YOUNG J:
But none of which relate to the value of the property?

MR L MCKAY:
And I will go on having established that the positive elements in favour of the 204 million lowest price by saying that doesn't matter, your Honour. Now, first of all, this is not a shock. The $204 million for the value of the shares in five years' time is two things. It is, first of all, it is justified fully by reference to their initial issue price in 2002. It is justified by the redemption of 40% of them in 2003 as part of this arrangement. It is more than justified by time value of money considerations.

WINKELMANN CJ:
Well, are you saying it's justified by the redemption of 40% because is there any calculation to show that they took that into account, because I thought you were just going to say it is justified by the time value of money?

MR L MCKAY:

Well, there's no calculations that I'm aware of as a matter of evidence about the redemption because you can't redeem shares at their fair value. You can only redeem shares in a tax efficient way, in other words, as a return of capital, but the paid up capital represented by those shares. That was $150,000 per share.

WINKELMANN CJ:

Yes, but what we're talking about is calculation of the lowest price.

MR L MCKAY:

That's correct and the further – I'm sorry.

WINKELMANN CJ:

And you're saying there's no evidence about what they took into account when they were calculating the lowest price?

MR L MCKAY:

One can imagine it though. One can imagine all the matters I've referred to because the number is so sensible. The number certainly takes into account time value of money.

WILLIAM YOUNG J:

It's all basically working back from the 204 million?

MR L MCKAY:

Yes, it is all working back and working back from 204 million.

WILLIAM YOUNG J:

This is just a bootstraps thing then, isn't it?

MR L MCKAY:

I'm sorry, Sir?

WILLIAM YOUNG J:

Isn't it just bootstraps? We put an arbitrary value on the shares in five years' time. We discount it to a present value.

MR L MCKAY:

Yes.

WILLIAM YOUNG J:

But it's all, it's highly contrived?

MR L MCKAY:

All of that. Well, it's contrived in the sense that any time value of money or discount consideration –

WINKELMANN CJ:

That's not right.

MR L MCKAY:

Well, this is what this is, but it's perfectly rational to calculate it in that way.

WILLIAM YOUNG J:

Well only within its own logical –

MR L MCKAY:

I mean it's a market rate of interest on the debt, okay, and this is a debt instrument. It's perfectly reasonable to take the same discount rate as applied to calculate what one imagines. This is an effective lowest price clause with reference to the convertible note itself. It's also justified though by external reference points. Those external reference points are the assumption that at the end of five years when the first right in property passes these shares will be worth around $200,000. That's just simply a matter of arithmetic.

GLAZEBROOK J:

It has to be said that lowest price is usually used in circumstances where you get the property immediately and have a deferred payment later.

MR L MCKAY:

Yes, I accept that.

GLAZEBROOK J:

Because usually it's used to calculate what the time value of money actually, the agreed time value of money is.

MR L MCKAY:

Yes.

GLAZEBROOK J:

So effectively it's usually used with a deferred payment of a price for property rather than the other round.

MR L MCKAY:

Yes.

GLAZEBROOK J:

So it is slightly artificial to use it in these circumstances, but what you're saying is you do exactly the same calculation –

MR L MCKAY:

You do.

GLAZEBROOK J:

– that you would do if you had a deferred payment of the purchase price. You would discount it back to work out what the lowest price was.

MR L MCKAY:

Yes.

GLAZEBROOK J:

In this way you're just discounting it up to get the lowest price.

MR L MCKAY:

That's correct.

GLAZEBROOK J:

But it's not actually how – the lowest price clause is usually used the other way round.

MR L MCKAY:

No, no, that's accepted but the respectful submission is it's a –

GLAZEBROOK J:

It's just a reversal of exactly the same exercise?

MR L MCKAY:

It's just a reversal. Why I say it, I'm sorry, and that was rude and inappropriate to say it doesn't matter is that the lowest price clause as a design that is not intended to catch good bargains or bad bargains. It's time value of money deferral based. It's again taking the loan analogy.

WILLIAM YOUNG J:

Then why did you tell us about, give us comparisons of what the purchase price of the shares was, what the redemption of the shares was?

MR L MCKAY:

I beg your pardon?

WILLIAM YOUNG J:

In terms of justifying the value you talked about the 60 million redemption of shares.

MR L MCKAY:

60, Sir.

WILLIAM YOUNG J:

The amount that Frucor was capitalised to buy the business, what was the relevance of those?

MR L MCKAY:

The relevance of that is that the parties at least were acting consistently. The parties initially issued the shares at a par value of –

WILLIAM YOUNG J:

They weren't non-voting shares though, were they?

MR L MCKAY:

No, profit participation shares, Sir. I suppose to turn the Commissioner's argument around, if the Frucor business already owns all the voting shares, then the significance of these and any other additional shares of a non-voting character is profit participation and I know my time is up. There is one further reference point.

WINKELMANN CJ:

Don't they already have a 100% profit participation?

MR L MCKAY:

I beg your pardon?

WINKELMANN CJ:

They already have a 100% profit participation.

MR L MCKAY:

Yes. Let's take this perspective and I suppose I am, again, with my usual respect, absolutely galled at the Court of Appeal's proposition that –

WINKELMANN CJ:

Galled?

MR L MCKAY:

Galled, G-A-L-L-E-D. It's like grumpy which I previously described myself as being. The notion in the Court of Appeal's quote that I read to you, your Honour, that there is no value in these additional shares. To follow that with the comment that as long as they didn't end up with a third party is something of a question beggar and a take it back. The fact was these shares had enormous value both under the actual arrangement and under the reconstructed arrangement because the Frucor business was sold to Suntory which is a Japanese company a short time after this arrangement terminated for $1.43 billion and I dare say, I suggest to you as a commercial matter Suntory would never have gone near the Frucor business. That includes the existing voting shares unless it had been able to ascertain to acquire these profit participation non-voting shares. So, if it matters, and it doesn't Justice Young, good deals and bad deals on the underlying property don't affect the operation of the financial arrangements rules.

Your Honour, I do have a couple of further points that can very easily be dealt with by way of reply to my friend's submissions because I am sensitive that he wants to make and you want him to make a substantive start now.

WINKELMANN CJ:

Yes, I think do it by way of reply.

MR L MCKAY:

So unless there are any further questions or comments those are the submissions of the appellant, your Honour.

WINKELMANN CJ:

Thank you, Mr McKay.

MR L MCKAY:

Thank you.

MR SMITH QC:

If your Honours please there are, first of all, some particular aspects of the approach in *Ben Nevis* and later cases which we say should be borne in mind in this appeal. It's not my purpose, of course, to go through the basic tenets of *Ben Nevis* but one or two aspects of *Ben Nevis* in particular which are of particular focus in this appeal. The first is without dealing with at the moment all the *Ben Nevis* paragraph 107 and 108 considerations, *Ben Nevis* and a number of other decisions make it clear that whether an arrangement is a tax avoidance arrangement depends on the factual scrutiny, i.e., an evidential review of what was put in place sometimes referred to as a review which is "intensely factual." I'm not going to take you to the actual cases, but we see that just by way of noting for example in *Ben Nevis* at 108, also at 123 to a lesser extent.

GLAZEBROOK J:

Are you giving paragraph numbers there, sorry? I just missed the first one.

MR SMITH QC:

108.

GLAZEBROOK J:

Thank you and 123, was it?

MR SMITH QC:

One of the trinity of paragraphs that we might take into account. *Alesco* 94 paragraph 94, that's at tab 7 of the main bundle of authorities. There's also just really by way of rounding it out there's *Cullen Group Ltd v Commissioner of Inland Revenue* [2019] NZHC 404, (2019) 29 NZTC 24-003, a recent decision in the High Court of his Honour Justice Palmer. It's not in the bundle, but the citation to it is in our footnote at footnote 36 and the paragraph is 62 and then there's *Russell v Commissioner of Inland Revenue* [2012] NZCA 128, (2012) 25 NZTC 20-120 in the Court of Appeal. Again, not in the bundle, but the citation is again in our footnote 36 and the paragraph number in *Russell* is 39 where it was said: "The parliamentary contemplation test is an

intensely fact based enquiry," and therefore the Commissioner is going to be asking you to consider the facts in some detail.

In addition, the next, well, the next overall point that I want to make is the question of cost and expenditure. Where an arrangement has involved claiming a deduction, the cases have always, even before *Ben Nevis* considered the particular factual although partly legal aspect which is the actual incurrence of the loss or expenditure which is being claimed and that has been central to the cases even before *Ben Nevis*. For example, and again I will just give the references not take you to the case volume, *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (CA); and *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 (PC) in the Privy Council at tab 4 of the Commissioner's volume at page 558 lines 35 to 40, page 561 lines 33 to 56.

WINKELMANN CJ:
Sorry, what was that last page reference, what last page reference?

MR SMITH QC:
561, your Honour lines 33 to 56, page 562 lines 10 to 15 and also lines 35 to 55. There is also *Peterson v Commissioner of Inland Revenue* [2006] 3 NZLR 433 (PC). That's in the Commissioner's volume in respect of shortfall penalties under tab 7 and that's at paragraphs 39, 42, 43. Then of course in *Ben Nevis* itself at 98, 127, 128 and then post-*Ben Nevis* extensively because of the particular fact circumstance in that case where there was a zero coupon convertible note at paragraphs 56, 70, 71, 81, 82 just to mention some of the paragraphs. The next overall –

ELLEN FRANCE J:
Sorry, what was that last case?

MR SMITH QC:
Alesco, if your Honour pleases. The next overall general legal consideration to be borne in mind stems from the definition of an arrangement. So an

arrangement includes not merely an arrangement or contract but also a plan or understanding and the plan or understanding need not be enforceable. All steps by which the arrangement, including the plan or understanding is effected, are part of the arrangement and I'm concentrating for the time being on the statutory definition which is at tab 2 of the Inland Revenue bundle on avoidance bundle of authorities. That sort of statutory concept of an arrangement or understanding has of course been considered in quite a number of authorities and statutory context outside tax, particularly securities and also the Commerce Act 1986 and in various other regulatory contexts.

It was considered some time ago in a decision of the Court of Appeal in *Ithaca* and *Ithaca* you will find under tab 2 of the third bundle of Commissioner's authorities. I just need you to note it for the time being. I don't need to physically take you there unless you happen to have it. It's under tab 3 of the supplementary bundle of authorities and that was a securities regulation case, but at paragraph 68, your Honour, in the context and more broadly of the securities legislation looked at the terms as they had been arrangement or understanding. So paragraph 68, those terms are used in trade practices and taxation statutes and have been the subject of extensive case law and judicial and academic comment. We refer to this, in this regard for example, to a list of cases including tax cases and Commerce Act cases as well.

Then in 69 it's clear from those cases that the terms arrangement and understanding describe something less than a formal contract. There may be little to distinguish one from the other except the matter of degree with an understanding likely to be more informal than an arrangement. What is clear from both the trade practices and the taxation context is that a meeting of minds is required. The meeting of minds and bodies and expectation as to future conduct meaning that there is a consensus as to what is to be done.

There is a small subsequent gloss on the extent to which consensus or a meeting of minds is needed and we find that in the Privy Council's decision in *Peterson* in 2005 which is behind tab 7 of the Commissioner's bundle of authorities on shortfall penalties and this will come up again in the context of

shortfall penalties later in the piece. But the relevant passage bearing in mind that the Privy Council is there considering section 99 of the ’76 Act, so at page 436 and paragraph 3 the Privy Council judgment sets out section 99 including section 3, section 3 being the equivalent of GB 1 and then some pages over at paragraphs 34 and 35 the Privy Council goes on to say: “Their Lordships are satisfied that the arrangement which the Commissioner has identified had the purpose or effect of reducing the investor’s liability to tax and that whether or not they were parties to the arrangement or the relevant part or parts of it, they were affected by it. Their Lordships do not consider that the arrangement requires consensus or meeting of minds. The taxpayer need not be a party to the arrangement and in their view he need not be privy to its details either.” And so obviously that is referring to what is now to be found in GB 1 as opposed to the earlier section 99 because the precise wording of GB 1 which we find in the further authorities is that a person is affected by an arrangement. It doesn’t require that a person is a party to an arrangement, so there is that gloss on the otherwise broad interpretation already given in *Ithaca*. So all that is needed is an arrangement that has a purpose or effect of reducing tax and that a person is affected by it whether indeed they knew it or not.

So, therefore, the fact the Frucor in this case may not have been a party to emails or communications recording the structure, or describing the steps to be taken in pursuance of it, in my submission, does not matter. In fact, Frucor doesn’t even need to have been a party to the arrangement, although it was, no matter how the arrangement is evidenced in contracts, or deeds, or letters, or side letters, emails, reports and presentations and file notes and the like.

Typically, in any event, both this Court and the Court of Appeal have been prepared to look well beyond the contractual documents themselves. An example is in *Ben Nevis*, for instance, where all the correspondence, or much of the correspondence which was relevant outside the transaction or documents themselves was looked at and I refer simply to paragraphs 135, 136, 137 through to 140 and for that matter, following in *Ben Nevis* where, for example, the letters which lay behind or provided a running narrative as to

how the transaction was to work were given considerable significance and weight by this Court in that case.

The final point, one I hardly need to make, is economic substance and commercial reality being a central focus. Now, before leaving off those general points and going as I intend to, to the documents, there was something which was said during the course of arguments about the willingness of the Court to look at documents outside contracts. Our position is simply this. There are two stages, stages 1 and 2. At stage 1 there is clear authority for the proposition in *Ben Nevis* and elsewhere that one has regard in the way that one normally interprets contracts using the normal principles of contractual interpretation to what is put in place as a matter of legal form under those agreements. Even at that stage it has to be said, of course, that there are many instances in which the need or opportunity will arise to look at documents outside those documents. At the high point, there is rectification, but quite apart from that, there is post-contractual conduct and there is any amount of material which is let in outside those more confined examples simply by dint of the development of the law since *Prenn v Simmonds, Hansen*, right the way through to *Re Zurich* in New Zealand.

All of that, as it turns out, is often permissive enough to look at documents outside written contracts in these cases, but where we are looking at an arrangement, or an understanding, then even those relatively, and I think my friend would say grumblingly loose restrictions don't exist in any form whatsoever. It is purely a question of whether or not the documents are documents which assist the Court in understanding what the arrangement was, what the structure was and what were the steps which are required to put it into place.

WINKELMANN CJ:
And what the purpose was.

MR SMITH QC:
And what the purpose was?

GLAZEBROOK J:

We're not at that stage. We are still on the first stage, aren't we?

MR SMITH QC:

No, on stage 2.

GLAZEBROOK J:

We're now on stage 2?

MR SMITH QC:

Yes.

GLAZEBROOK J:

Okay, sorry, I think I lost you half way through.

MR SMITH QC:

Yes, I'm sorry.

GLAZEBROOK J:

Well, I thought you were saying that there is clear authority at the first stage that you can actually look at documents outside as well anyway.

MR SMITH QC:

Only as a matter of contractual interpretation because of the changes which have happened.

GLAZEBROOK J:

Yes, that's how I had understood it.

MR SMITH QC:

But now, at the second stage, obviously even those increasingly less restrictive principles don't apply at all. It's purely a question of whether you derive assistance as to structure, steps in place and as the Chief Justice mentions, the purpose and of course the effect of the arrangement. In some cases, some of the documents may comprise the arrangement. An instance

is the side letter, or help comprise the arrangement. In other instances, they simply describe steps and the parties' expectations as to what was to actually happen as to elucidate the purpose of the arrangement not because of their expectations or because of what was intended, but because of what they said would happen in the structure which was in place to make it happen.

Now, turning then to those documents, I intend, the bundle of documents you have makes it look, if I begin at 40, as if I'm going to take you to a great many of them. I'm not. There might be 10 or 15 and none of them are particularly long. The first is a document which was at or near the inception of this arrangement, and you find it under tab 40, it's 304.0841.

GLAZEBROOK J:
You have to give us a bit of time to scroll down, sorry.

MR SMITH QC:
I'm very sorry. And so what you should have in front of you is a slideshow in print form, "Efficient financing alternatives for New Zealand, Danone," dated January 2002, which corresponds with the date of the purchase of the New Zealand company. A couple of pages over, that's 0845, second paragraph: "In the following document we would like to present you two alternative structures which have both been executed in New Zealand and have received positive ruling from local tax advisors," names convertible note and then a second one which is sale and lease back, I guess, of trademarks. Then down the bottom: "Deutsche Bank has already worked on the arrangement and execution of several such structures in different jurisdictions, including New Zealand," so it is an off-the-shelf tax product. Then several pages over at 0848, we there have the convertible note structure of summary description, and in the second paragraph there is a reference to what is the equivalent of Danone Asia Pacific: "Alternatively countries such as Germany or Luxembourg could be considered." So it's clear that there will be another company in the group that has to fit into the position of a company which is able to receive the shares back in a form which won't attract tax, but it doesn't

matter where. They're suggesting alternatively countries such as Germany or Luxembourg but it happens, as it turns out, to be Singapore.

Then the next page, 304.0849, summary of the tax that's right. The first bullet is: "Coupons paid by New Zealand entity on the convertible note would be fully deductible. There should be," it's the second point, "no capital gains tax on the acquisition of the NZSPV shares purchased by Danone UK subsidiary provided that such shares are not sold," and swap out the UK subsidiary for DAP there. Left as it is, there might be some basis for suggesting merely in the order of the benefits that the New Zealand tax benefit came first, but for the time being I don't make the case purely on that, it is sufficient to show by itself that it was a particular feature, and certainly a good deal more than incidental. And as time goes on I propose to advance the proposition that it was, at least for the purposes of shortfall penalties, a dominant purpose. But for the time being I don't need to go that far.

The next document I wanted to go to is under tab 43, which is 304.0861, and this is email dated the 4th of February, so we've moved on by as much as a month. It is an internal Deutsche Bank document written by a Mr Rough and it's to another Deutsche Bank person, Peter Kirch, who has obviously asked: "What's happening with this presentation that we've made?" because he's told by Mr Rough: "Actually, yes, they," meaning Frucor, "have now confirmed they want to go ahead with the convertible structure. Next steps they've asked are for (i) New Zealand memorandum/opinion confirming deductibility of coupons and (ii) UK memorandum/opinion relating to forward purchases and a term sheet." Again they then talk about the fee: "We looked at the Argentinian deal," so it's a template. But the third paragraph, fees: "They have suggested upfront arrangement fee of one million plus credit spread." Then further down: "The fees for these transactions in Europe are generally 1% of the principal. Here the principal on the notes is only about 80 million. Of course, that turns out to be 55. You will see that the numbers at this early stage change round quite a bit, but here you can just say it's 55 million is what they're talking about in the final result.

Down the bottom second to last paragraph: “Accordingly we should probably accept this, but let me know what you think. There is also a lot of glory in this DCM who have been trying to develop the relationship with Danone.”

WILLIAM YOUNG J:
What was that, what Deutsche Bank capital markets, or what?

MR SMITH QC:
As I understand it, yes. So, as the witness Professor Choudhry, whose evidence I will come onto shortly said, even without seeing that, an email, he would have concluded that there certainly is a lot of glory in it. This is what the transaction from Deutsche Bank structured capital markets is all about. They, as will be seen in the fullness of time, earn virtually nothing by way of funding from this transaction. All of it is in the fee which they get which eventuates it being 1.8 million, but in addition there is considerable kudos as an investment bank for Deutsche Bank to bring this product to Danone so that they can use it.

Now, the next document is some tabs over and it is the Pricewaterhouse opinion. I will give you the number first of all, 304.0885.

WILLIAM YOUNG J:
What’s the tab number?

MR SMITH QC:
It’s tab number 45, and that is opinion which was spoken of at least from the UK sub, or as it turns out the DAP company to establish that the receipt of the shares at the arrangement’s termination will not attract tax in Singapore and as I am going to suggest in the fullness of time, the Court of Appeal were completely right in deciding that this was a waypoint or a checkpoint on the way to ensuring that the real benefit of this transaction, namely tax efficiency in New Zealand, this was simply ticked off and if I’m going to say that, then I simply, I need to refer you to where that was ticked off. That is it.

WINKELMANN CJ:

So, I understood from Mr McKay that one of the tax advantages was to stop the interest payments that were being made by Frucor in New Zealand being taxed deductible on receipt by the financing company.

MR SMITH QC:

We would say that wasn't a tax advantage. That was a requirement for this transaction to proceed because if the shares on receipt back in Singapore would be taxed, it would nix the point and value of the arrangement, but in itself it wasn't the point and value of the arrangement and that is the reason why the Court of Appeal came to the view that, I'm not sure that I've paraphrased correctly.

WINKELMANN CJ:

No, no, what I'm saying is the point of value of the arrangement was the restructuring itself which stopped all those taxable receipts in the original financing company.

MR SMITH QC:

It certainly had the effect of doing that and that was a prerequisite for this transaction, or this arrangement to be entered into because otherwise it would derogate from the benefits to be experienced in New Zealand. But we would characterise it differently from the way in which my friend Mr McKay has. We would say that while that carried with it a benefit, there are other ways to achieve that such as, for example, a simple equity injection or to do something else. In the terms of this arrangement, it takes its place rightly as a box to tick to ensure that the benefit of the arrangement is being tax efficient.

GLAZEBROOK J:

You're going to have to, I think, slow down or speak, because I just didn't catch that.

MR SMITH QC:

I'm very sorry.

GLAZEBROOK J:

And I think it's quite important.

MR SMITH QC:

There obviously is a difference between the parties about the point and value of, the importance in this in terms of the shares being received back in Singapore not being taxable. My friend says that is a purpose and he would like to say that is the purpose of the arrangement. We are saying that isn't the purpose of the arrangement. Tax efficiency in New Zealand, that is to say, deductibility of as much of the coupon as could be made deductible according to the structure was the point and value of the transaction.

GLAZEBROOK J:

I can understand that except that they wouldn't have done this restructure would they without it not being taxable in Singapore?

MR SMITH QC:

Absolutely.

GLAZEBROOK J:

Because there wasn't any point. Well, because there wouldn't have been any point in doing that. You would have just have probably lent some more money and redeemed the equity.

MR SMITH QC:

Yes, that is exactly my point.

GLAZEBROOK J:

I change the structure and you would have had exactly the same deductibility?

MR SMITH QC:

Depending on comparative rates, yes, and I think the rates were quite comparable.

GLAZEBROOK J:

Yes, well yes, obviously.

WINKELMANN CJ:

So is it one way to analyse this that in order to get rid of the tax problem they had with Frucor paying off the money advanced to them by Danone Finance S.A. they needed to swap that into equity, but in order to maintain the tax advantage for Frucor, they needed somehow to be debt, so they needed two different things on different sides of the transaction?

MR SMITH QC:

Well, that's absolutely right, but what I am saying is that –

WINKELMANN CJ:

So, in some ways it's a little bit like *Alesco* where they're trying to marry in a transaction, two quite different things, to get tax benefits on both sides?

MR SMITH QC:

Yes, it is, although I would characterise it differently by saying that the point and value of the arrangement was tax efficient funding in New Zealand and just as her Honour Justice Glazebrook has said, it's no use if you do that from a group point of view, you end up with an impost in another jurisdiction. So it was a necessary checkpoint to ensure that under this structure and bearing in mind that this is a structure which has been hawked around a number of jurisdictions by Deutsche with some success, they simply have to come up with a jurisdiction where the receipt of the shares, anyone will do, is not going to attract tax.

WINKELMANN CJ:

I think I must have something factually wrong then because I had thought that part of the reason for this whole restructuring was to stop the fact that Danone Finance S.A was receiving a whole lot of taxable income in repayment on the interest.

MR SMITH QC:

That was not the whole point of the transaction.

WINKELMANN CJ:

No, no, a point.

MR SMITH QC:

A point, okay.

WINKELMANN CJ:

A point. Was that a point of the transaction?

MR SMITH QC:

No. We say two things.

WINKELMANN CJ:

It seemed to me it was because by putting it into two, they had stopped.

MR SMITH QC:

I'm sorry, I didn't quite hear that.

WINKELMANN CJ:

Well, if you stop it being debt and make it equity, you get rid of the –

GLAZEBROOK J

Equity, no you're speaking at equity at the DAP level.

WINKELMANN CJ:

Yes.

GLAZEBROOK J:

The inter-DAP.

MR SMITH QC:

It's a purpose and effect. What we say is that the purpose and effect of the arrangement for New Zealand tax purposes was to get tax efficient funding in New Zealand and from any other point of view and this will become very, very clear. It's mentioned as the predominant issue, if not the sole issue in all of the documents I'm going to come to and perhaps the best way of dealing with this is just to come to those documents as I intend to shortly. It's merely, as I say, a checkpoint and as the Court of Appeal said, to ensure that DAP in Singapore doesn't end up with an equal and opposite effect as a result of entering into this arrangement because that begs the question of what would've been the point of entering into it in the first place.

WINKELMANN CJ:

Was it more tax efficient than the funding it already had?

MR SMITH QC:

Well overall –

WINKELMANN CJ:

Because of course it was repaying debt.

WILLIAM YOUNG J:

It was really because in fact there's $144 million owing to the French DA finance company. As a result of this, there's $144 million owing to the French bank and Deutsche Bank of which $55 million is going to be able to be repaid using deductible –

MR SMITH QC:

As a deductible coupon.

GLAZEBROOK J:

Or alternatively, the interest on the 144 was not taxable whereas before it was taxable. That's the net effect of this and this is the only point of this transaction being done in this particular way. I'm not saying that negatives the

55 or any arguments like that, but I don't think you can shy away from the fact that there was no point doing this transaction if you landed up with a taxable income on the interest income.

MR SMITH QC:

Overseas, or in another part. No, not only do I not shy away from it, that is absolutely factually correct as a conclusion, it's just a question – and there are only two questions. The first is was that just a waypoint, in other words it's not the purpose of the –

GLAZEBROOK J:

Well, it has to be the purpose of why you do the refinancing, otherwise there's no point in doing it, is there?

MR SMITH QC:

Or whether it is, it somehow renders the New Zealand end of the arrangement less than something –

GLAZEBROOK J:

Well, that's I think your best argument, as well as the way that it was structured in terms of the 66 million repaying the 55 plus interest.

MR SMITH QC:

What I'm saying is we'll come to this in the documents presently, but at the absolute bottom line you couldn't possibly suggest, in my respectful submission, that the New Zealand tax effect was merely incidental. It had to have been a significant feature of the transaction. And perhaps it's just best if I just go on to the documents and then we'll see that as we come on.

WINKELMANN CJ:

Well, just before you do, just to clarify this last point for me, what was their taxation position before they did this restructuring with the money they had – they were able to claim the deduction or the interest they were paying?

MR SMITH QC:

Yes, but they were having to – it meant that the interest that they were paying or liable to pay and able to deduct was genuinely interest, it didn't at the same time remove debt as well. And under this transaction effectively the same dollar performs both functions. Now the next one I was going to go to was 50, and 50 –

GLAZEBROOK J:

So is the outside – it might not be right time to ask this. But it's really – because if this transaction had just been done with no outside funding at all, which it could have been, would the argument be the same? So effectively the same sort of structure had been put in place but you leave Deutsche Bank out of it.

MR SMITH QC:

Yes. If that had occurred, then the argument would be the same because it would been an arrangement from the start, that notwithstanding that Deutsche Bank weren't introduced to it, what was paid off, what was used at the end to discharge the principal, were shares, after the coupon had been paid for five years and had been fully deducted, claimed the deduction, and at the end of that the value for the shares, which be ascribed to the share as discharge of the principal, would equally have been arrived at a wholly artificial, on a wholly artificial basis, and so in point of fact – and that, the only –

GLAZEBROOK J:

Well, I mean, it's not totally artificial, is it, in the sense that it's not a situation where there was no value in the company whatsoever, because I can understand the artificiality there. But effectively their value of the shares was arrived at in terms of the time value of money.

MR SMITH QC:

No, in my respectful submission it wasn't. The only thing that was arrived at in terms of the times value of money was the it's $149 million in plus times a rate over five years which produces the 204 million. The 204 –

GLAZEBROOK J:

Well, that's the time value of money, isn't it?

MR SMITH QC:

Yes, it is, but that's got nothing to do with the shares. There's no attempt in this case to link that value to the shares in the share capital of Frucor…

GLAZEBROOK J:

Well, so if they'd done and said: "Well, the shares, let me do a calculation in terms of what the shares are worth," which you would do…

MR SMITH QC:

No, no, it would be different.

GLAZEBROOK J:

Based now. So if I bought those shares now they'd be worth X amount of money.

MR SMITH QC:

Well, the difficulty with this case was that –

GLAZEBROOK J:

Oh, it's the other way round, because normally you'd be doing lowest prices the other way but…

MR SMITH QC:

We'll come to it presently, but the way that –

GLAZEBROOK J:

I'm probably leading us down a rabbit hole so perhaps I should just let you really…

MR SMITH QC:

Well, I will deal with it a bit here whilst we're here at the moment and we're almost at five to four, but the way in which Mr Choudhry looked at this was that this wasn't a listed company so nobody knew externally anyway what the shares were worth so it was very unusual as a convertible note. If it was a convertible note and it conformed with what is ordinarily what you see is a conventional note, then as we all know, it would've been issued to the parties on market. If it wasn't, then there would have been a prospectus or other issuing document. That would be backed by a discounted cash flow projection which would tell the investors in the convertible note what it is that they might be able to expect in terms of exercising the volatility play embedded in the convertible note at one or other of the option or mandatory dates which came up and just to be a little more detailed and attempt to be clear about that, we would also know that if this was a public offer by way of a convertible note, we would have a lead manager or a joint lead manager, a First New Zealand Capital or some other such organisation such as Forsyth Barr with their analysts pouring all over this second guessing the projections in the notes in their independent capacity, recommending purchase or no purchase to their clients. There would be other parties as well as them who would be carrying out discounted cash flow analyses to work out whether or not as a cross-check, do the DCF calculations in the prospectus. In other words, there would be considerable work and considerable transparency as to the value of the stock and the stock, albeit infuturo, would be the subject of genuine valuations actually relating to the prospects of the company and/or its net tangible asset value or based on multiples.

Here, it was nothing of the sort. There was no value given to the shares other than through the mechanistic and mechanical compliance with the financial arrangements rules, the lowest price clause and that in turn was derived purely by means of an arithmetical calculation. This is, in my submission, a

very clear example of the sort of thing in the same general context which Lord Templeman described in *Challenge* as a mechanical and mechanistic compliance with a specific rule in order to achieve a result. Those shares in this case could have been worth anything. Who would know? It was simply decided that a letter would be entered into and signed with an interestingly precise number derived purely from an arithmetical calculation having nothing to do with the value of the stock.

I was going to go next to tab 50 and tab 50 is a Deutsche Bank document headed up "Project Falcon."

GLAZEBROOK J:
I'm sorry, 50 of what?

MR SMITH QC:
Volume 3. I promised I was going to give you the page. It is 304.0911. Project Falcon at the top.

GLAZEBROOK J:
To be honest, I hate the way this index works, but we're stuck with it at the moment.

MR SMITH QC:
I see it's just on, I was going to spend some time –

WINKELMANN CJ:
Do you want to finish on this document or do you want to start on it tomorrow, it's over to you?

MR SMITH QC:
No, I haven't started it. I will start it tomorrow if I can.

WINKELMANN CJ:
Okay.

MR SMITH QC:
Thank you.

WINKELMANN CJ:
We will retire then I think.

COURT ADJOURNS: 3.59 PM

COURT RESUMES ON WEDNESDAY 9 JUNE 2021 AT 10.02 AM

WINKELMANN CJ:
Mr Smith.

MR SMITH QC:
I was just about to start talking about a document under tab 50 which is 304.0911, and this is an internal Deutsche Bank note headed up "Project Falcon" and you'll see from it that it appears to be the third iteration of a track-changed document, and amongst other things that have changed are the numbers as it becomes more clear from the rates which they will apply as they are nearing the signature date what the actual numbers involved in the transaction are going to be.

WINKELMANN CJ:
Because the unmarked-up one is earlier, isn't it?

MR SMITH QC:
I have one, I think under tab 46, which is unmarked.

WINKELMANN CJ:
Yes.

MR SMITH QC:
So there's one missing, being the in-between one, unless it's there, which it isn't.

WINKELMANN CJ:

That's all right.

MR SMITH QC:

So just looking at it, starting for the present with the third bullet point: "The structure involves Deutsche, New Zealand Branch, subscribing for a five year convertible note issued by DHNZ. The note will pay interest semi-annually and convert into shares to be issued by Frucor in five years. Frucor will enter into a prepaid forward sale of the shares with Danone, DBNZ will enter into a prepaid forward sale. DHNZ will receive net funds from the transaction of approximately 64," which of course is 55, "and this will be the net credit exposure that the Bank has on Frucor, guaranteed by Danone." And then over the page, paragraph 2, third line – second line, under the forward purchase agreement, this is where the details are set out in a more granular way: "Receives on conversion of the DHNZ convertible note –

WINKELMANN CJ:

Sorry, what page are you on?

MR SMITH QC:

This is on 0912 under the heading "Structure" with the Roman iii, paragraph 2.

WINKELMANN CJ:

Right, got it.

MR SMITH QC:

Starting line 2: "Under the forward purchase agreement DBNZ will be obliged to deliver the shares it receives on conversion of the DHNZ convertible note to DAHC." It's interesting the way in which the people involved in it saw the arrangement from a commercial point of view, they didn't get themselves unduly tied up about the possibility of settling in cash, all as provided for somewhat more minutely and legalistically in the forward purchase deed, but just saw it as an outright obligation, no doubt in commercial terms, to return the shares. "DAHC will prepay the purchase price under the forward

purchase agreement. The purchase price payable by DAHC on day one will be calculated as the face value of the convertible note less the present value of convertible note coupon payments discounted at the rate to be agreed with Danone on the rate set." Then, 3: "DBNZ will fund the net investment, approximately 64," read 55, "from its treasury via an amortizing loan at the swap rate," and then down the bottom: "On termination in five years anticipated that DBNZ will exercise its option for the convertible note to be redeemed by the issue of a fixed number of shares." They cross out "ordinary" shares presumably to reflect the fact that the shares to be issued are in fact non-voting it it's to be…

The point of all that at the very highest level is perhaps summarised best in the summary under A on the preceding page, 0911, in the first bullet point under "Summary", second sentence: "The structure provides term funding to DHNZ at an after-tax cost that is significantly below the Group's normal cost of funds, ie, pre-tax equivalent of approximately minus 1.5%." Now that of course is analysing the position from the Group, the point of view of the Group's normal cost of funds. But what it does mean is that essentially there is, the company is being paid to borrow, and that is a factor which is driven from really only one thing, which is the tax effectiveness of the arrangement, which is driven purely from tax deductions in New Zealand.

GLAZEBROOK J:

Well, that's not quite right, is it? Because doesn't the funding actually, or the lower rate, come because it's non-taxable at the other end? Because they'd get the tax deduction anyway but the – because whether they, they could have refinanced just ordinary debt and increased the debt equity ratio, done exactly what they were doing, it's just they would have been doing it at a higher rate, and the only reason they'd be doing it at a higher rate would be because it would be funding just at the normal rates and the interest would be taxed at the other end.

MR SMITH QC:

I have to say that I don't know, and the Commissioner doesn't know, what happens with the money which is returned to DaFi, the French finance company. It could be that they had a wholly different use for the funds or, alternatively, they go ahead and fund another company in the Group, in which case they earn interest from that instead and, indeed, they have to pay tax on that, I accept all that, we simply don't know. So, yes, if your Honour pleases, it may well be that there is a contributor to the lessening in cost of funds from the factor that you've mentioned but, whether or not there is, it must be the case that the New Zealand tax deductions are making a significant contribute as well.

GLAZEBROOK J:

Well, but if you had a higher cost of funds there'd be a higher tax deduction in New Zealand because there would be a higher interest rate, wouldn't there? I mean, if you borrowed from offshore – if you borrowed from somebody else at a particular rate and then leant it on to the subsidiary, then if you were going to actually allocate the interest cost it would actually be a higher, not a lower interest cost, that you were allocating. So it's been getting a lower cost of funds here, then actually a lower tax deduction than they would do on another structure.

MR SMITH QC:

Well, as I understand it, the effect of this is pre-tax.

GLAZEBROOK J:

Well, no, they say it's an after-tax cost, it's significantly below.

MR SMITH QC:

They say it's a pre-tax equivalent of approximately minus 1.5%, so that the actual rate comes down to less than zero.

GLAZEBROOK J:

Ah, well, maybe it's explained in the, or can be explained a bit more in reply.

MR SMITH QC:

So the next document I wanted to go to was 54, and this is a little later on, or somewhat later on, namely at the end of November.

WILLIAM YOUNG J:

What number?

MR SMITH QC:

Sorry, this is 304, tab 54, 304.0923.

WINKELMANN CJ:

Did you take us to document 49, have you taken us to document 49?

MR SMITH QC:

I don't think that, let me just check whether I did.

WINKELMANN CJ:

I found that quite helpful in terms of understanding what was going on.

MR SMITH QC:

No, I didn't take you to that document. I'm sorry, that document is the PricewaterhouseCoopers opinion.

WINKELMANN CJ:

And I think it makes the point somewhere that what is happening in substance is a loan of $55 million.

MR SMITH QC:

Yes. That is what it says and because I hadn't intended to take you to that one your Honour because so many of the documents do, but if that says that somewhere, then that would be a correct observation and is of assistance generally.

Anyway, I had intended to go to 54 which essentially says the same thing. This is Mr Burridge from Danone, sorry, from Deutsche Bank to other

Deutsche Bank people dated the 29th of November 2002 and it describes in general terms what the central features of the arrangement are where at 210 million, which presumably as at that time has been roughly worked out as the face value of the note given the rates which applied at that time but still the amount which Danone is prepared to put in we say as an equity injection as per 2, paragraph 2, is 149.

WILLIAM YOUNG J:
I've got the wrong document. What are we looking at?

MR SMITH QC:
This is 0923.

WILLIAM YOUNG J:
I need the tab number, sorry.

MR SMITH QC:
I'm very sorry, it's tab number 54.

WILLIAM YOUNG J:
This has got four paras in it?

MR SMITH QC:
Four short paragraphs in it, that's it, Sir. So, again, they are nearing the execution date. We're now just really a matter of a few months, at the end of 2002 where the execution to take place in the first quarter of the following year and, as I say, the figures are changing, although the one unchangeable figure is the amount which Danone is prepared to put in as we say as an equity injection. But having described the principal features of the arrangement in items 1, 2, 3, 4 we then have Mr Burridge saying: "The net effect of the above is that Danone raises approximately NZ dollars 61." Again for that read 55 million for x many years. There's a typo there. It doesn't say five, but I'm sure it's meant to say five "on an amortizing basis." The next document.

O'REGAN J:

When is says Danone there, that's the Danone Group or is it talking about the New Zealand company?

MR SMITH QC:

I think that they're just talking about Danone, using it as a general term.

O'REGAN J:

Earlier it talks about Danone Holdings NZ which presumably is Frucor, is it?

MR SMITH QC:

Yes, it is, but I wouldn't really be drawn one way or the other as to whether the author of an email has intended to keep purity about the entities right the way through.

GLAZEBROOK J:

Well, there's new money coming in from Deutsche Bank of 55.

MR SMITH QC:

Yes.

GLAZEBROOK J:

Wherever or however you look at it, isn't it?

MR SMITH QC:

Yes.

GLAZEBROOK J:

That's your point really, isn't it?

MR SMITH QC:

Yes and it's amortized as a loan as he says in the email.

O'REGAN J:

Then the 61 became 55 later, did it?

MR SMITH QC:

61 became 55 later, so the key number throughout, at least from an early point is 149 and then with the application of the rate which is to be set on the rate setting day which we come to presently in the following year, that then drives the value of the note at the precise 204 million x many thousand dollars.

WINKELMANN CJ:

Mr Smith, I think just taking you back to document 49 and not wishing to obsess about it, but there was something else there that caught my attention when I was reading through these documents which was it says: "There is no change in equity interest held by DHA and DHNZ."

MR SMITH QC:

I think I know what you mean. May I just know where the paragraph is, your Honour?

WINKELMANN CJ:

So, it's on page 304.0904. I'm just wondering if that's earlier iteration or is that sort of an in substance take?

MR SMITH QC:

Well, I suppose what that would reflect, just reading that paragraph in isolation, is that they're talking about the arrangement in the large. That's to say that albeit that there will be shares which are issued. If there's an election for the conversion of the notes, those shares will find their way back to the parent first of all and so the only change –

WINKELMANN CJ:

So, it will own everything just as it did before?

MR SMITH QC:

I'm sorry?

WINKELMANN CJ:
It will own everything just as it did before?

MR SMITH QC:
Just as it did before and the only difference is that the shares, share capital are somewhat differently denominated and there have been some costs in the issues of the shares in terms of procuring board resolution, the transfer, and Companies Office registration costs.

Then I was going to go to 55. I should just add in relation to that, there was no change in equity interest held by DHA DBNZ. The other point to make about that is that it probably is –

WINKELMANN CJ:
Are you on 55 or 49 yourself?

MR SMITH QC:
I'm back to 49 just while your Honour was on that. The other point to make about that of course is that there is a central dispute between the Commissioner and the taxpayer as to whether or not the 149 was an equity injection or whether it represented simply part of a larger debt of 204. We have always said that that is an equity injection and I will come to that presently. We have always said that in point of fact it is factually wrong on a commercial and economic basis to characterise this arrangement as an increase in debt in New Zealand. It is in reality an equity injection upfront on day one of 149 million passed on by Deutsche Bank directly on receiving it to Frucor.

GLAZEBROOK J:
You're coming to why you say it's equity, are you, so you're coming to that, did you say?

MR SMITH QC:

Yes, yes. So there is then, I was going to go to 54 and 54 is just a waypoint again we're at 149. This is at 0924 and we're at 149 forward purchase price again and the convertible note principal is at 211 again, purely as a product of the application of the rate which would apply if the execution took place on that day.

Then we have an interesting document which is over the page under tab 56 and its page number in the bundle is 304.0925. Although it appears at this point in the bundle because the other document showed we're at the end of 2002, it probably is a little earlier and I only say that because if you look at the second box by the word "reason for presentation", there's new, New Zealand dollars 225 structured transaction and that is the number which was being used in May of that year as we see from tab 46 and tab 46 as an earlier, or the earliest iteration of the Project Falcon note that I took you to at a later iteration under tab 50. This is just by way of saying this document is out of order in terms of the sequence but otherwise of assistance.

"The reason for presentation, new, New Zealand dollars 25 million, five year structured transaction. See appendix 1 for description, which is designed to provide cheaper tax efficient funding to a subsidiary of Group Danone in New Zealand under the transaction."

GLAZEBROOK J:

I'm sorry, I'm just not quite sure where you are.

MR SMITH QC:

This is on page 0925. It's towards the top of the document.

WILLIAM YOUNG J:

I have to get the tab numbers also.

MR SMITH QC:

Tab number 56.

GLAZEBROOK J:

Okay, so where are you?

MR SMITH QC:

In that document I'm in the second large box under the heading "Loan loss prov" and there's bold "reason" on the left-hand side.

GLAZEBROOK J:

Loan loss?

MR SMITH QC:

Loan loss prov.

WINKELMANN CJ:

Reason for presentation.

MR SMITH QC:

Reason for presentation, one, New Zealand.

ELLEN FRANCE J:

It's on the first page.

MR SMITH QC:

Dollar 225 million.

O'REGAN J:

Right up the top of the page.

GLAZEBROOK J:

Okay, okay.

MR SMITH QC:

Towards the top of the page and, as I said, describes the amount: "See appendix 1 for description which is designed to provide cheaper tax efficient funding to a subsidiary of Group Danone S.A in New Zealand." Down the

third to last bullet point: “Difference of NZD71 million will be amortized from the convertible coupons. Nominal payment is estimated at 87.” So we’re talking larger numbers at this stage again. After conversion, which of course is a certainty, Deutsche Bank will deliver the shares and retain the payment from the forward purchase agreement. So, again the tax effect right to the fore.

The next document is under tab 57, the next tab and it’s page 0926. This is a Deutsche Bank document transaction headed up “transaction memo Project Falcon.” Background: “Project Falcon is a New Zealand dollar financing transaction which allows Danone to fund its New Zealand holding subsidiary, a wholly owned subsidiary of Danone.”

WINKELMANN CJ:
Sorry, what tab. I’m sorry, what tab are you at?

MR SMITH QC:
Under tab 57.

WINKELMANN CJ:
57, thank you.

MR SMITH QC:
And it’s page 0926. A New Zealand dollar financing transaction which allows Danone to fund its New Zealand holding subsidiary et cetera, et cetera, a wholly owned subsidiary of Danone Asia Pacific, DAP as we call it, in a tax efficient manner via DB New Zealand. DHNZ requires the funds as part of its long-term financing of an acquisition of a New Zealand operating company.

And again under the end of the second paragraph: “On termination, a fixed number of shares will be issued by DHNZ to DBNZ which will in turn deliver the shares to DAPL.” So, again, the rationale for the arrangement is front, left and centre.

I then want to go to some documents which concern the setting of the rate and the first of those is under tab 64 which is at page 0947. So, this is on the 7th of March 2003 quite close to the execution date and it's an internal document written by Mr Scott Burridge from DBNZ to various other people in DBNZ. It's an email headed up: "Please note that rate setting signing now expected on Wednesday the 12th of March with cash flows on the 14th of March so just around the corner." And you will see that in the bundle there is a flurry of emails and communications as they near the rate setting, the determination of the face value of the note and then execution and following attending to the cash flows.

"In addition, the funding," it says at the top of the email "arrangements with TSY and OTC attached below. DBNZ will receive pay as follows. Receive the forward purchase price 149, pay to Danone Holdings NZ the NZ dollar note issue price, ie, the total of 149 plus NZD PV amount.

GLAZEBROOK J:
I think I might be on the wrong document. Where are you?

MR SMITH QC:
I'm at page 304.0947.

WINKELMANN CJ:
Tab 64.

MR SMITH QC:
Tab 64. I'm sorry, your Honour Justice Glazebrook, I thought that you were using the page numbers rather than the tabs in particular.

GLAZEBROOK J:
No, I am, I just can't find the bit you're talking about, that was all.

WINKELMANN CJ:

We have to use both, Mr Smith. We have to get into the document through the tab number.

MR SMITH QC:

I see, right.

WINKELMANN CJ:

Because of the PDF format.

MR SMITH QC:

Right, I'll not forget. Now if your Honour pleases it's at –

GLAZEBROOK J:

It would be wonderful if somebody could just put the documents up they're about, but unfortunately that doesn't happen.

MR SMITH QC:

It happens in international arbitrations but I imagine there's a different funding model involved.

GLAZEBROOK J:

Yes, exactly.

MR SMITH QC:

So 0947, under tab 64.

GLAZEBROOK J:

Yes, okay, I think I've got the right document now.

MR SMITH QC:

So, Mr Scott Burridge, 7th of March 2003, two other Deutsche Bank people, he being a Deutsche Bank person himself: "Please note that rate setting/signing now expected on Wednesday the 12th of March with cashflows on the 14th of March. In addition, the funding arrangements," et cetera, et cetera, "will

receive/pay as follows. Receive the forward purchase price of 149 from Danone Asia. Pay to Danone Holdings New Zealand the NZ dollar note issue price, ie, the total of 149 plus NZD pv amount agreed with client (this pv amount will be equal to or less than the NZ dollar received from TSY as set out below." I don't know who TSY are but they are involved. They are part of Deutsche Bank and we come onto emails about them later on.

WINKELMANN CJ:
Treasury?

MR SMITH QC:
TSY?

WINKELMANN CJ:
Treasury?

MR SMITH QC:
It must be Treasury, yes. The person involved is Mr Adrian Todd, and we'll come to his emails presently. And then it sets out after that –

WILLIAM YOUNG J:
What's OTC?

MR SMITH QC:
I don't know where it comes from. But Treasury and OTC are, well, divisions within Deutsche Bank, as I understand it.

O'REGAN J:
This isn't controversial, is it? I mean, everybody knows how the 55 million was derived.

MR SMITH QC:
It shouldn't be controversial, but my point in taking you to it is to show, as I'll say later on as well, looking at the evidence, is that unlike an ordinary convertible note there is precisely no attention paid to the funding needs of

the New Zealand company in any of this. The exercise and the pricing of the note is wholly and thoroughgoingly driven by nothing but the need to produce a face value which, based on the rates used at the time, provides enough, when you remove the 149, to give a balance which will be lent and will be paid off with a coupon comprising interest and principal, but equally because of the rate-setting mechanism, if the coupons are treated as interest only, will amount to a commercial rate on the face value of the note. And, as I say, my purpose in taking you to that is to say that it is an aspect of the contrivance and artificiality of the arrangement. There is no purpose, as the documents not only show but say, but no purpose to this arrangement other than refinancing on a cheaper and more tax-efficient basis.

GLAZEBROOK J:

Well, if you're actually looking at a commercial purpose, financing on a cheaper basis is actually a good deal commercially. So if you, just on any general basis, if you can find cheaper finance you do.

MR SMITH QC:

Granted.

GLAZEBROOK J:

The question is where does the cheapness come in, and the argument that you're facing is the cheapness comes in from the fact that you have a non-taxable receipt in Singapore. So you have a lower rate that you're actually paying overall and a lower deduction in New Zealand for a higher percentage of debt but still under thin capitalisation.

WINKELMANN CJ:

And your answer to that would be I take it Mr Smith that if that was the case why would you characterise this as a loan?

MR SMITH QC:

Correct and in any –

GLAZEBROOK J:

I don't understand the answer, sorry.

WINKELMANN CJ:

Well, you answer it Mr Smith.

MR SMITH QC:

The difficulty with the argument, if that is the argument that I'm facing, it doesn't do anything.

GLAZEBROOK J:

I'm sorry, for some reason there are some voices that come through absolutely abominably on our sound system.

MR SMITH QC:

Am I one of them?

GLAZEBROOK J:

And oddly yours is one of them.

MR SMITH QC:

I'm very sorry.

GLAZEBROOK J:

So, I don't know why that is but everybody found that yesterday.

WINKELMANN CJ:

I think it's everybody's voice. We might have something wrong with the sound system, so don't take it personally Mr Smith. If you maybe just speak up because we couldn't hear Mr McKay all that clearly either.

MR SMITH QC:

Oh, I see.

WINKELMANN CJ;

We will have to get them to look at it. It's picking up voices in quite a faint way.

MR SMITH QC:

I see.

WINKELMANN CJ:

So, Justice Glazebrook said to you: "Well, isn't this really, yes it's a tax efficiency thing but the tax efficiency it's looking for is by structuring this as a capital investment on the Singaporean side, it's on the Singaporean side and that's a tax efficiency," and I said "but if that were so, why is it structured as a loan on the New Zealand side to gain the tax efficiency there." And you were going to explain that.

MR SMITH QC:

Well the difficulty with the argument which is made is that the tax efficiency in my submission can only come, can only be driven out of the New Zealand tax base and it is obviously achieved –

GLAZEBROOK J:

So you say that you don't look at alternative structures and the total ability for this to have been structured as a refinancing, I mean just a total refinancing to go up to 66 rather than 50/50? That would've been what because presumably at a higher rate because the cost of funds would be higher. So if Danone had borrowed the extra 55 million at a higher rate and put that in along with its 149 as a straight loan then in fact there would have been a higher cost of borrowing in New Zealand and a higher deduction?

MR SMITH QC:

Yes, but correspondingly, the deduction would have been a permissible deduction because it would have been actual interest.

GLAZEBROOK J:

So, do you say you can't look at that as being a totally legitimate way of structuring this because they chose to structure it another way to get a lower cost of funds which was based totally on the Singapore?

MR SMITH QC:

We can't, we shouldn't for a start be looking at it as something as it isn't. There is *Alesco* which is on its own terms is authority for the proposition that one should not look at hypothetical scenarios.

GLAZEBROOK J:

Well, that's a Court of Appeal decision. It's not this Court's decision.

MR SMITH QC:

Yes, I'm quite aware of that. I'm simply saying that it is of some value to you in this, but even if you were to be able to look at a hypothetical account to factual, and I'm only putting this forward from *Alesco* because in my submission it's correct, you would also have to have some evidence that that was an alternative which the company would seriously have contemplated and we don't have any evidence that that is the case at all here. In fact, what we do have is the arrangement of this structure from the very earliest stages more or less commensurately with the purchase of the New Zealand asset by Danone and you can see that from the first document that I took you to under tab 40 which is the slideshow presentation. That presentation was made to them at about the same time, to Danone by Deutsche Bank at about the same time as they completed the purchase. But apart from that we have, there is no other evidence that there were other possible structures in view.

The next point is that, well that means that we're stuck with the one we have and the one that we have has its distinctive features that dollars which are paid comprising the coupon essentially do double duty. Whereas under any possible arrangement, such as a straight loan, the dollars which would be paid in a syndicated loan would go straight to interest, and nothing else. In this case they, at the same time, or should I say 55 out of 66 million of them, not

only pay what is purported to be interest, but in addition principal as well. We say they can't be both, they have be one or the other, and when you have regard to the whole of the arrangement, it is clear that what – on the documents, without looking at any other documents, that what we have is an amortizing loan comprising part of a face value of the note, which is paid off as to principal and interest on it. So we say that it cannot be a correct position as a matter of economic and commercial substance that the coupon payments at the same time can discharge principal but also pay interest.

GLAZEBROOK J:

That will happen, though won't it, in many cases, if you have differential interests rates so that you don't have an interest rate, you have an interest rate that's going to be charged at the end. So if you actually just had an ordinary instrument where the money is going to be charged at the end, you could well be paying interest but having that applied to principal. I mean it's your strongest point, I think, but not necessarily in terms of recharacterisation. I think for me you would have to be able to characterise that 149 as equity, which is why I'm interested in hearing from you on why that would be the case.

WINKELMANN CJ:

Just before we move onto that, can I perhaps just take you back to the start of this, because I think where we started with was the question of the relevance of any tax advantage in Singapore to this analysis, and your argument doesn't depend on showing that there was no tax advantage in Singapore, does it?

MR SMITH QC:

No, the only –

WINKELMANN CJ:

It just has to show that is a purpose of, a not incidental purpose of the transaction to have tax advantage in New Zealand.

MR SMITH QC:

We say that's not a tax advantage. As per yesterday's discussion, we say that is a requirement. It's not a tax advantage. That there would be no tax on the return of the shares is a requirement for this transaction, this arrangement to proceed, otherwise it would effectively remove the benefit of the tax retreatment in New Zealand, and that's the reason for instance clause 3.4 of the forward purchase deed, namely the gross-up in the unlikely strike impossible event that Deutsche Bank elected to take cash or didn't elect to conversion, in which case the Singapore company is out of pocket unless and until the formula in clause 3.4 is a gross-up is applied and it's put back in the position that it ought to have been. So that is the only overseas effect which we say is clearly understandable on the evidence that you have before you. If there are other overseas effects, as I'm sure there will be, because there are, it could be that DaFi receives funds and does something else with them. We don't know what that is, we have no way of knowing what it is. If it is relevant and capable of providing a defence then it is the taxpayer's onus in these cases, given that these are proceedings brought by the taxpayer not us, it is simply their concern. We go no further than the tax status of receipt of shares in Singapore as a result of this arrangement.

The other point is the question of incidentiality, whether it's merely incidental in New Zealand. If we were to say that so far as Singapore is concerned, if we were to accept or you were to find that as far as Singapore is concerned the receipt of the shares tax free was a purpose of or effect of the arrangement, then we would say that so too still was the tax-free, the claiming of deductions in New Zealand, and that has to have been a purpose which was not merely incidental.

GLAZEBROOK J:

I'm sorry, you're going to have to repeat that.

MR SMITH QC:

We say that we're not obliged, except for the purposes – I'm putting it slightly differently now – except for the purposes of shortfall penalties and whether

you would want to say that the taxpayer had not merely taken an abusive position, sorry, an unacceptable tax position, but had also taken an abusive tax position. Then we would be required to show that the dominant purpose was deductions in New Zealand, and we say that that is in fact the case. But if you were to take the view that we were wrong about that and it wasn't a dominant purpose, nevertheless it is *a* purpose and it is not merely an incidental purpose, so that even occupying that somewhat less important status it still suffices for tax avoidance in New Zealand, it just "downgrades", one might say, if we use that language, from the purpose or effect or a not too, a not merely incidental purpose or effect.

WINKELMANN CJ:

So to secure the Singaporean advantage, though, you didn't need to structure the loan to secure the New Zealand tax advantage – yes, you didn't need to structure it in the way it is structured, which secures the New Zealand tax advantage?

MR SMITH QC:

Well, one would assume not, and that in fact would be my point. We would say –

WILLIAM YOUNG J:

Isn't it more than that? There was no point in creating a capital profit in Singapore except the desire to create a deductibility in New Zealand?

MR SMITH QC:

Correct. And so –

WILLIAM YOUNG J:

I mean, it's an entirely artificial transaction.

MR SMITH QC:

It's an entirely artificial transaction, and so it would be, how would we say, a pity in Deutsche Bank terms and in Frucor terms for that to be ruined, and this

is really so obvious from the documents, because the parties took great care to make sure that if for some other reason the tax effect in Singapore came to life, namely that there was a receipt in cash as opposed to in shares, then there was a gross-up. But all of that was, as important and elaborate as it was, was subsidiary to, at best, their main purpose.

WILLIAM YOUNG J:
Well, I take it there's no document that says that the purpose of this is to make a capital gain in Singapore?

MR SMITH QC:
No.

WILLIAM YOUNG J:
Puts that as front and centre of the proposal?

MR SMITH QC:
No. Well, what is front and centre, as we see from these documents, is just the tax effect in New Zealand.

WILLIAM YOUNG J:
The tax-efficient funding model for the Danone New Zealand subsidiary.

MR SMITH QC:
That's exactly what it is. And the further we go away from that, other than to acknowledge, I would say, in not much more than passing, that it was important to secure the value in order to secure the value of that that you didn't queer the pitch, as it were, in Singapore, it becomes progressively less useful, relevant and necessary to consider what might have been the use of funds which were, if it were to go beyond, on Singapore. There is no evidence about it, we don't know. I can imagine that were it to be of any relevance or value we would have heard about it from the taxpayer, who has the onus on this in any event. But for ourselves it is New Zealand.

I'll just see if I can skip through the further documents I was going to take you to more expeditiously than I have been so far. Under tab 65, this is another email from Mr Burridge from Danone. This time too it's not an internal, and it's page 0949, and it's not an internal document, that it goes also to Mr Pierre-Andre Terisse of Group Danone, dated the 7th of March 2003, quite close to rate-setting and signing: "I understand from Boris Baroudel" who is inside Deutsche Bank "that it's proposed that the documents for the NZD funding be signed on Wednesday. We are working on the assumption that all the requirements for the necessary opinions will be satisfied by then. Below I summarise the proposed arrangement for the rate setting and signing of documents and flow of funds. Can you please let me know if you do not agree with any of these," and he sets them out.

Adrian Todd, from Deutsche Bank, and I think he's in London: "Will contact you to advise you of the five year New Zealand dollar swap rate and the consequential interest rate for the convertible note issue. Assuming these rates are satisfactory to you, the present value of the coupons will be determined and this will be added to the forward purchase price of 149 to give the convertible note issue price." So again, absolutely no doubt about what is going in. It's purely a question of the convertible note face value as an instrument being driven by as Professor Choudhry says and he comments on this in his evidence and I will come to it later on, being purely driven by a swap rate calculation designed for the purposes of paying off whatever extra over it is which Deutsche Bank in New Zealand has to tip into the deal in order to make it work for New Zealand tax purposes.

Then that's the end of that volume and I want to go next to tab 67 and this is an email which records dealings with Mr Adrian Todd and also with Mr Pierre-Andre Terisse of Group Danone. Adrian Todd, on the 13th of March has forwarded it on to Mr Burridge in New Zealand and then the email itself appears dated the 3rd of December 2003 and that is from Mr Todd to Mr Pierre-Andre Terisse where he says: "My swap rates are on the BTMMNZ on Bloomberg," which I assume is a Bloomberg product. I think it's beat the market maker. "Though at closing we'll be trading out of hours for the

New Zealand dollar curve and so we may have some small differences. I have attached a curve and a model to calculate the funding amount and indicative levels as at March the 12th. In summary, swap rate of 5.815, funding of, therefore, of 54.9 million," and then he gives a 60 basis points adjustment.

Then in the third bullet point there is this sentence: "At execution I shall not try to calculate your pre-tax equivalent benefit from the transaction, only the coupon rate and to the net funded amount." I assume that he's saying: "I'm not going to do that in addition because this is the result near enough." "However, it should be approximately net funding amount," which is going to be the, as it turns out the 55, "by the tax rate divided by one minus the tax rate less –

WILLIAM YOUNG J:
The tax rate was what, 28 cents?

GLAZEBROOK J:
Where are we on?

WINKELMANN CJ:
We're on 67.

MR SMITH QC:
33, the tax rate, 33.

WILLIAM YOUNG J:
I see. Yes, all right.

MR SMITH QC:
So, anyway the tax rate over one minus the tax rate less the US 1 million dollars which will be the fee and I think that might have been subject to some change as well, but it doesn't matter because he goes on to say: "Which is roughly 24 million and interest only." In that calculation, the pre-tax equivalent

benefit on the face of it is really only being driven by the New Zealand tax rate.

WINKELMANN CJ:

I have a recollection that in one of the documents, and I may be wrong in this, but I have a recollection that in one of the documents in relation to the Singaporean tax advantage there is a statement that the convertible note should be kept separate from the purchase of the, they should not be linked because linking them would imperil the Singaporean tax advantage?

MR SMITH QC:

Yes. There was, you are correct in your recollection and it is in one of the PWC letters and it is advice to the effect that delinking the two instruments, or turning them into two different instruments would be preferable from the point of view of Singapore tax and that's as I understand it, a reason why that was done. In the break I will see if I can find what letter that is so I can take you back to the passage.

I was going to go next to 68 and 68 is simply the calculation, no sorry, I don't want to go to 68, unnecessary. I want to go to 74.

WILLIAM YOUNG J:

Can I just ask a question about that? I don't understand the arithmetic. I can't see why the tax saving isn't 18.15 million, why you don't just take a third of 55, but I don't understand? I understand there's also minus a million, but why is it divided by 67%?

MR SMITH QC:

The answer is I'm not sure what is the reason for that calculation as opposed to the calculation you would prefer to do.

WILLIAM YOUNG J:

Well, it's not my preference. It's the only one I could do actually. That's no doubt a confession.

WINKELMANN CJ:

Your juniors might know the answer. I can see some Post It notes being written on.

MR SMITH QC:

The overall answer is that whatever the benefit is it's been driven by the New Zealand tax deductibility of this arrangement. 74 is a –

GLAZEBROOK J:

Are you going to another tab?

MR SMITH QC:

Yes and it is 74 at 0962 and this simply a Scott Burridge email to people inside Deutsche Bank simply confirming the signature of the document and that's where they get the note price and also that the net, or the final net funding amount of 55,421,565.

Then over the page we have a post-signing Project Falcon signature note, or a post-signature note which is essentially Deutsche Bank's –

WINKELMANN CJ:

Are you on 74?

MR SMITH QC:

I'm on 76 and it's page 0964, sorry over the…

WINKELMANN CJ:

Yes, got it.

MR SMITH QC:

Asia Pacific post-signature note, so their summary of the transaction basically for future reference and to make sure that for internal purposes that they don't forget to do something that they have to do such as, for example, by a set time in five years' time they are required to give notice that they elect to

convert to shares and they obviously can't have corporate default, memory defaulting on that so it describes the transaction on page 966 which is intrinsic page 3 down the bottom, brief transaction overview, third paragraph: "Net funding requirement is therefore the difference between the convertible note issue price and the share forward purchase price. Funding will be serviced by the convertible note interest payments."

Next paragraph: "The funding for the net amount note subscription less prepaid forward purchase price was provided by DBAG by way of a five year NZ amortizing loan to be fully serviced by the note interest payments."

And then several pages over on 969 3.5 referring to the loan: "This loan is fully amortized over five years and serviced from the interest payments received on the note. The loan payments are as follows."

GLAZEBROOK J:
Sorry, what paragraph is this?

MR SMITH QC:
This is 3.5.

GLAZEBROOK J:
Thank you.

WINKELMANN CJ:
So, this is what sits behind the mask on your account?

MR SMITH QC:
Yes. Then 77, these are just transactional documents. For the record, at 77 you've got the note, this is the note under tab 77, at page 980, and then I wanted to go over some pages to tab 96. We then have at tab 96 the 20 February 2008 election to convert to shares, not that that comes as a surprise, and then after tab 112 we then have the, at page 1149, a document headed up "When the scheme was established". We don't know the

provenance of this document, except to say that it was attached to the taxpayer to its statement of position, so it comes from the taxpayer. And over the page there is the heading "What was the point of the scheme?" and it simply says: "The scheme allowed DHNZ to finance the purchase of Frucor in a way which entitled it to tax credits for the life of the scheme", and we would look long and hard for a better and more succinct description of the purpose and effect of the arrangement than that.

Tab 120, at page 1167, Frucor refinancing the scheme, coupon settlements, the paragraph I want to go to is the one halfway down the page about: "Note, at the beginning of the scheme Danone Asia had paid Deutsche Bank a sum of 149 to have Deutsche Bank deliver the shares they receive from DHNZ in 2008. In effect, the net borrowing for the Group from Deutsche Bank would only have been 55."

WINKELMANN CJ:
So what document was that?

MR SMITH QC:
This is the document under tab 120 and it's page 1167. And I just want to just for a moment there divert and talk about the way Professor Choudhry described that in his evidence at this point. So Professor Choudhry towards the end of his evidence-in-chief, but it's oral questioning, you find at page 202, it's in volume 2B of the evidence, it's under tab 8, and it's at page 0243, and it starts at the top on intrinsic page 139 of the notes of evidence and evidence-in-chief, and so he has that document put to him: "Just tell us what it shows," and…

GLAZEBROOK J:
Sorry, can you give me the page number you're on again?

MR SMITH QC:
0243 of the notes of evidence. So it's in volume 2 –

GLAZEBROOK J:

It's all right, I'm on the thing, I just didn't know what page.

MR SMITH QC:

And so what Professor Choudhry's looking at at this point is this note, 120, and also the, well, as part of the note the attached spreadsheet, which is on page 305.1169, which shows the principal deduction payments. So he's asked: "Just tell us what it shows," he answers: "Okay, so it's basically showing you the breakdown of the New Zealand dollar swap curve to start with. So you see right at the top you see the swap rate of 6.05%. He's there talking about the exhibit you see on page 1,169 and then a coupon spread on top of that 45 basis points, but of course the 10 and the 35 are what Deutsche Bank pays. To the right of that, just to explain, that moniker he calls it, that's the Bloomberg identifier for those tenors, namely the length of the loan. So New Zealand 0003M, that's a three month LIBOR fixed all the way down to SW2, 3, 4 and 5. That's the 2, 3, 4, 5 for the New Zealand dollar swap rate. So that in effect, in that box, is the New Zealand LIBOR swap curve and then there is the date of close 18 March 2003, or when they're fixing the price. It then takes the next six months. It takes the forward rate from the LIBOR curve plus the spread and you work out a discount facts from that and then it works out, it basically works out the present value using the discount factors of the starting balance. So, you move along to the right, you see the column balance, the starting balance of 55 million and you pay that all down to zero and it shows a breakdown of principal interest once you've applied the discount factor to each of these numbers and so on.

Then over the next page, intrinsic page 40, the question is half way down the page at line 14: "Is that a normal way to set the face value of a convertible note?" And he says: "No, normally any capital market note, whether it's a vanilla Eurobond or a convertible bond, or a structured financial security, normally there's two things driving it and it's no surprise it's supply and demand. The borrower will have an idea of how much money it wants. It will say 'we need 100 million or 200 million or a billion to, you know, set up a new subsidiary, to buy plant, equipment, to buy a factory, to pay salaries'. It will

have a funding requirement and if it's got a credit rating it can go to its underwriting bank and say 'okay, right, we'll raise 100 million or x million in the capital markets. That's our financing need', and the underwriting bank, if it's a deal runner, if it's a book runner, will say 'okay, we'll talk to the investor community. Your credit rating is x, let's say A or BBB, or what have you and we expect you to have to pay a coupon of say 5%'. They will then, well it's called undertake a period of what's called book building. They'll talk to their investor community and they will gauge the level of demand for this borrower's paper, the bond, it's bond issue." So that's the way that, in terms of the issue of convertible notes, or as this witnesses called them from time to time convertible bonds, or, indeed, any similar investment product, that's the way in which it would be priced. This indicates the comparatively artificial and contrived nature of deriving the face value of the bond or the convertible note in this case. It's purely a product of present value using a swap rate derived at the time when the amount of the 149 million is to be paid upfront. It's got nothing else to do with the funding of the company.

WINKELMANN CJ:

So, artificiality is twofold. The amount that they're seeking, there's no evidence it's what the company needs and the second thing is they can't do what's conventional which is go to the market and book build to work out the rate they have to set? They couldn't do that because it's an inter-company thing.

MR SMITH QC:

Because it's not listed and it's a wholly owned subsidiary, that's right. But what it tends to indicate is, in my submission, the somewhat artificial and contrived nature of using a bond to achieve this result. It is only by using an instrument such as this that we arrive at the result that what looks to be externally on the face of the convertible note deed interest payments as a matter, we say, of commercial and economic analysis, in fact mainly repayment of debt.

Then that's as far as I wanted to go so far as these documents are concerned, at least for the time being and I think permanently. The convertible note, if we just go to – I'm going to go presently back to Professor Choudhry in relation to some, in my submission, particularly artificial and contrived features of the arrangement, including the note and the forward purchase deed. But before going to what Professor Choudhry has to say about this, we say that on the evidence you've seen so far and that which the Court of Appeal saw the conclusions on the facts that you would reach are as follows.

First of all, in economic substance the 204 million paid to Frucor under the note by Deutsche Bank, of that 55 million was obtained from Deutsche Bank intra-group lending and the balance of 149 was obtained from DAP under the FPD. We can also see that there was no realistic prospect that DBNZ would elect to receive cash or that, having elected to convert to and receive shares that it would retain them. Next, that the shares had no value –

WINKELMANN CJ:

You might want to slow down. There was no realistic prospect that Deutsche Bank would keep the shares, they would not convert?

MR SMITH QC:

Yes. Third, that the shares had no value to DAP, it was already Frucor's 100% owner and the shares were non-voting. There was some talk about that yesterday but again, if we look at the question of the value of the shares from two perspective, from the point of view of Frucor it begins and ends by being the 100% owner of the subsidiary. The only difference or the only perturbation on that continuing state of affairs is the fractional point of time during which DB elects to receive and does receive the shares and then passes them back to DAP.

GLAZEBROOK J:

Sorry, just say that again.

MR SMITH QC:

The only change in DAP's 100% owning of its New Zealand subsidiary is the very brief moment in time when the shares are in the possession of Deutsche Bank under this arrangement.

Looked at from a number of perspectives, first of all from the point of view of Deutsche Bank the shares have no real or, indeed, any value to it, not just because they're non-voting shares, but in addition it is having elected to convert, which it must do economically and commercially, it is obliged contractually to pass them on, it simply can't keep them. So putting aside all tax and tax avoidance aspects of the arrangements in a tax context, for instance, if Deutsche Bank had unaccountably wished to hang on to the shares, its non-voting shares, then it would have been in breach of contract and one would think that there would be a ready remedy which is available. However that is to take a somewhat lawyerish, if I may say, and non-commercial and non-economical and impractical approach to what would happen here. Because, as we will see from Professor Choudhry's evidence and as we've seen from the documents themselves, for wholly separate reasons, entirely commercial reasons and entirely non-legal reasons, there was no chance of Deutsche Bank hanging on to those shares. This was a tax-efficient financing product which Deutsche Bank on the papers had sold in other jurisdictions and also in New Zealand.

WILLIAM YOUNG J:

Do we know what's happened in other jurisdictions where the product's been sold too?

MR SMITH QC:

I know that in terms of the other jurisdictions one of them was Argentina, so I don't know, that was on the face with that earlier document.

WILLIAM YOUNG J:

But that didn't proceed, did it? I'd an understanding that one didn't go through.

MR SMITH QC:

There was just a bare reference to it happening there. I don't know how far it got or whether it did or didn't reach completion. I haven't drawn from that document that it hadn't reach completion. There were other overseas countries which are referred to in the presentation document under tab 40, including in New Zealand, and this structure has, the convertible note structure has been used in New Zealand in a number of other cases similar to the one which you're hearing at present. This is the only one which has gone to trial.

WINKELMANN CJ:

So it's been used in New Zealand?

MR SMITH QC:

It has been used, or similar variants of it have been used in New Zealand.

O'REGAN J:

What about in other countries, do we know of that?

MR SMITH QC:

The only reference that I have to that on the evidence is in tab 40, their presentation document. If there's another one there I haven't seen it. But, of course, different or no general anti-avoidance rules in other countries anyway so it may not serve to inform your Honour or all that much if it had been used elsewhere.

And again, just looking at this possibility of Frucor retaining the shares in terms of what their value would be, as I said, unthinkable enough given that it would be in breach of contract, but quite apart from that as you will see from Professor Choudhry's evidence, but from the documents you've been taken to as well there was no chance that commercially, even if there was some other reason why they would want to do it, Deutsche Bank would ever have done that. It would be a reputationally damaging thing to have done to say trust us, we will send these shares back to you, there's no problem about that as part

and parcel of a financing arrangement which we have used as a template in various jurisdictions and then not do it for no better reason that they saw greater upside.

GLAZEBROOK J:
I think that's all accepted, isn't it by the other side. I don't think there's ever any suggestion that Deutsche Bank that was going to retain the shares.

WINKELMANN CJ:
I think that's right.

GLAZEBROOK J:
The significance of it rather than the fact of it.

MR SMITH QC:
That is absolutely accepted, but what my point goes to the question of the value of the shares. No value from Deutsche Bank's point of view and because of that it is an inevitability that they get returned to DAP which as per the status quo ante becomes again and remains the 100% parent so that there is no value in the shares either to DAP. It's a foregone conclusion they will get them.

GLAZEBROOK J:
It's a slightly odd argument, isn't it. That is true and not true. It is just that the value per share, if you've got 10 shares, you look at the value per share by looking at the underlying assets or a discounted cash flow or however you do it and if you've got 10 shares and you have that value and it's $1,000, then that value. But if you have 500 shares, the value per share is going to be different and you might own all of them, but whatever it is your value per share is going to be different?

MR SMITH QC:
Well, that's purely a question of the denomination of the shares and the share capital of the company, but the point is that they have been the 100% owner.

For a brief moment in time they were less than 100% owner. Once they revert to the status of 100% owner, they are entitled to do with the shares as and how they see fit. It matters not in the slightest to them how the shares and the share capital, all of which they own, are denominated irrespective of whether they're a thousand shares at X price or 2,000 at Y price.

GLAZEBROOK J:
Well, it's not really the 100% is the point though, is it? Isn't your point that there wasn't any commercial reason for doing this apart from the transaction?

MR SMITH QC:
My point. That's exactly my point. My next, the fourth point I wanted to make is a conclusion that you would draw from the evidence is that the principal amount of the note and the interest was carefully struck in a rate setting exercise so that the nominal value of the twice annual coupon payable for five years equalled the market rate for interest on the whole principal sum but was also enough to pay off 55 million advance to DBNZ.

Next the economic and commercial substance of the arrangement is that the 149 million is, as a matter of economic and commercial substance, an equity injection from DAP, passed by Deutsche Bank as a conduit, Deutsche Bank adding 55 million to it, that amount being paid off with interest over five years.

GLAZEBROOK J:
I suppose that's where I have slight difficulty, because I must say that the forward purchase smells and looks, as you say, like a financial instrument, because it's not set by anything to do with the value of the shares whatsoever, it's not set in the traditional way in terms of a book-building to see what the rate would be because it's related to the tax advantage, but it still looks like a debt instrument to me. So if you look at the whole transaction, why is it an equity, is it because it converts to the shares at the end of five years, or why is it equity?

MR SMITH QC:

It's equity when you look at the whole arrangement, because it converts to shares at the end of the five years and economically and substantially the only reason for the deferral to equity in five years, or the deferred payment, was to allow time to pass so that the amount added by Deutsche Bank could be amortized by what purported for tax purposes to be the interest-only coupon but in fact paid off the amount which Deutsche Bank advanced as well. Deutsche Bank's top-up, if we like, of $55 million in itself was added for one reason and one reason only, to enable the very process that I have described, payment off of apparently interest, which in fact was payment off of principal and a little bit of interest at the same time. So commercially and economically –

ELLEN FRANCE J:

Sorry, payment off of what? What did you say? You said Deutsche Bank's top-up of 55 million was added to enable the process.

MR SMITH QC:

The process that I've described to take place, namely that time would go by, namely the five years, over which 11 or 10 payments, twice-yearly payments, of what purported to be interest were able to be paid, which were carefully calculated to appear to be interest but also to be enough to pay off the additional amount which Deutsche Bank put in of 55 million. So there was no purpose to the Deutsche Bank addition of 55 million. It wasn't as if, for example – and we've been through this in some detail – but it wasn't as if for example anybody in Danone had gone to Deutsche Bank and said: "We need this for an extra factory or a plant or something else, and we need 204 million because that is the estimated project cost at this point." The sole reason or the addition of $55 million was to allow a time cost of money to pass so as to render the payments which were made to have the appearance of interest payment, there was nothing more to it than that. So when it's viewed –

WILLIAM YOUNG J:

Sorry, can I just ask, isn't the $149 million just nothing, it just goes round in a circle and has in the end no effect on assets, money available to Danone or Frucor and no –

MR SMITH QC:

It's wholly circular, it is nothing.

GLAZEBROOK J:

Where's the circularity?

MR SMITH QC:

Because, well, it ceases to have any relevance, it's –

WILLIAM YOUNG J:

Well, it's paid back immediately. $204 million goes from Deutsche Bank to Frucor in the round and $149 million comes back immediately.

GLAZEBROOK J:

But that happens with any refinancing, that's what I can't – that's what, well, I'm just finding where the circularity is.

WILLIAM YOUNG J:

I think, to my way of thinking, that is the circularity.

GLAZEBROOK J:

But that would mean –

WINKELMANN CJ:

Well, Mr Smith, can you perhaps explain the circularity to us?

MR SMITH QC:

The circularity is the use, the simultaneously use of the money. Because straight away on signing, without any delay, $60 million worth of

shares are brought back and an amount of equity funding is, on the surface of it, paid back as well. So 89 –

GLAZEBROOK J:
You mean debt funding?

MR SMITH QC:
Yes. So, 89, if we go back to the diagram that my friend had at the beginning of his submissions I think it's on there and he took you through them. It's $89 million back on day one plus another 60 and that's what the funds were used for. So, there's no, as I say, there's no purpose given that the funds go back straightaway and we will come to Mr Choudhry's evidence to show this. The circularity indicates that although yes, it is funding, there's no question that it is funding and it's for the purpose of funding, but the funding was pretty much there anyway and this a change of funding to derive tax benefits. That's what all the documents say right the way through and it might as well be taken from those contemporaneous expressions of how the transaction was set up that they indicate the effect and purpose of the transaction.

Next point is that in my submission the Court of Appeal did rightly conclude that the arrangement portrayed as interest what is in reality mostly principal repayment so that at the end of the five years DAP is left with its equity injection and DBNZ have been repaid its loan portion and for the equity injection, DAP receives via DBNZ the shares having no economic and commercial value to DAP, it being Frucor's parent. So, when they say that the effect of the arrangement is to, in their words "dress up" what are mostly principal repayments as solely interest, that is an accurate description of what occurred. We simply say that that enables but for section BG 1 the taxpayer to claim as deduction the full amount of coupon when in fact the major part of it is debt repayment.

The manner in which the deduction is brought about through the use of the convertible note we say is artificial and contrived and I've dealt with that to

some extent already, but what I haven't done is taken you to as much of the evidence of Professor Choudhry on the subject who largely wasn't challenged on any of this and I wanted to before I finish on this part, to take you to the principal parts of his evidence. You find his evidence under tab 7. That's his printed evidence-in-chief of volume 2A and it begins at page, the text begins at page 201.0184. There's no doubt that he is eminently qualified and he sets out –

GLAZEBROOK J:
Sorry?

MR SMITH QC:
201.0184 is the start of his evidence.

WINKELMANN CJ:
That's his qualifications.

MR SMITH QC:
And it's under tab 7 of the first evidence volume. So anyway his qualifications are not a matter of dispute as to their sufficiency. He is a PhD in financial economics London University. He's published extensively on debt capital markets. His industry experience includes IBO treasurer of Royal Bank of Scotland, a position in KBC Bank from The Netherlands.

WINKELMANN CJ;
Yes, I don't think it's in dispute that he's hugely qualified.

MR SMITH QC:
Yes, it's almost depressingly qualified. His first bit of evidence I wanted to take you to is at paragraph 29 where under the heading he uses, he talks about the conventional use of convertible note instruments. 29 put simply: "A convertible bond or a note as referred to in this case is a hybrid capital market instrument that combines features of debt and equity. They are primarily issued by corporate borrowers. A conventional note pays a fixed coupon for a

fixed term, these being features of a vanilla bond instrument on maturity or in some cases at specified points during its life. The bond converts to the issuer's equity. This may be compulsory or by bond holder election. From the investor view, this enables equity to be acquired cheaper than if shares were subscribed for at the time of a note maturity. In other words, a convertible note is both a coupon bearing investment as well as an equity volatility play with the investor hoping to benefit from the interest and the issue with market valuation. Because of the optionality feature which carries potential as well as time value for the investor, the coupon payable on a convertible note is lower than what, the same issuer would be required to pay for a vanilla debt."

Then, that's 28. Then 29, 68.2 on page 0200, 68.2: "As noted above the coupon payable on a convertible bond is generally lower than that payable on a vanilla bond issue of identical tenor for the same issuer at the same time. The FHNZ note does not possess the key 'attraction' of that conventional convertible bonds have because there is no equity option value. As such the coupon rate should be close to what a vanilla bond coupon rate would be (which was the case here). But other than being near market levels, the coupon rate on the FHNZ note is less relevant in this case, because the Deutsche Bank AG perspective this is a fee-driven transaction (unlike, say, a syndicated loan where a return is derived mainly from the loan interest rate)."

And his comments towards the end on the note, 84, the benefit identified at paragraph 76 of Mr Marcello's brief of evidence, Mr Marcello was the sole witness for the taxpayer.

GLAZEBROOK J:
Sorry, I missed the paragraph number.

MR SMITH QC:
It's 84. "The 'benefit' identified at paragraph 76 of Mr Marcello's brief of evidence i.e. five-year funding at a fixed interest rate over the term could have been obtained easily using an alternative vanilla fixed-rate financing structure. The convertible bond structure would not have been unique in offering this

benefit to FHNZ irrespective of what the previous group funding interest rate basis had been."

Then at 85: "Notwithstanding what Danone International Treasury stated at the time of the issue, the interest rate on this convertible bond is not a 'cheap' form of funding. The coupon was at market levels for an A-rated borrower in New Zealand dollars. If FHNZ had obtained financing through a bilateral bank," like this, "line this would have been, assuming a group guarantee, at a similar interest rate."

So in other words certainly there was cheap funding but it wasn't driven by the rate which was used to derive the payments.

Then he says at paragraph 30, going back a little bit: "The specific case of the FHNZ convertible note, and its use in conjunction with the FPD, is not conventional or orthodox in any investor-borrower sense, and I have only observed them used in anything like this manner where there is a tax-related issue driving the transaction."

WILLIAM YOUNG J:
Can I ask you a question. Just something that Professor Choudhry said and I think 71, was it. Para 70. "In essence the funds went back to DAP ($60 million) and Danone Finance Paris ($144 million)." Do you see that at the end of paragraph 70?

MR SMITH QC:
Yes.

WILLIAM YOUNG J:
Now I would have said that the funds went to, that $144 million of real money comes in via BNP and Deutsche Bank. Add those to –

MR SMITH QC:
I'm sorry 149?

WILLIAM YOUNG J:

144 million, 89 million plus 55 million comes in from BNP and Deutsche Bank and that, the same amount is paid to the Danone Finance company, and that's all that really happens.

MR SMITH QC:

In essence yes.

WILLIAM YOUNG J:

Yes, I just, I don't think the money does go to DAP and Danone Finance. I think the 55 million plus the 89 million go to Danone Finance Paris, and the rest just disappears in two puffs of smoke. One at the beginning of the transaction and the other at the wind up.

MR SMITH QC:

Yes, and all that's left is the 55 million amortized.

WILLIAM YOUNG J:

Yes.

MR SMITH QC:

That's exactly it. All the other numbers become irrelevant.

WILLIAM YOUNG J:

I read that and when I looked at it I didn't actually agree with it. That proposition.

MR SMITH QC:

I see. Right. So the next paragraph I –

WINKELMANN CJ:

Well I think it's time for a break.

COURT ADJOURNS: 11.31 AM

COURT RESUMES: 11.48 AM

MR SMITH QC:
Just two matters to catch up with, stemming from before the break. The first is a question which his Honour Justice Young had concerning an email which was written to Mr Pierre-Andre Terisse, and that was the document which appeared under one of the earlier tabs, tab 67, page 0951, and the question was –

WILLIAM YOUNG J:
How did he get there?

MR SMITH QC:
How did we get there, how did we account for that finding? The short point is that we agree with your calculation, Sir, which is that first of all the factor should be 33.

WILLIAM YOUNG J:
Okay.

MR SMITH QC:
In which case the exact figure which you would arrive at using the net funding of 55,421,565 would be 18 million 289,116 –

WINKELMANN CJ:
Rather than 24?

MR SMITH QC:
I'm sorry?

WINKELMANN CJ:
Rather than 24, is it, in that particular…

MR SMITH QC:

Rather than 24. And –

ELLEN FRANCE J:

So it would be 80 million 29…

O'REGAN J:

289.

ELLEN FRANCE J:

289.

MR SMITH QC:

289,116.

WILLIAM YOUNG J:

But less a million.

MR SMITH QC:

Well, that would, yes, but that would be – yes, less a million.

WILLIAM YOUNG J:

So it's 17 something or other.

MR SMITH QC:

Correct. On the other hand, nobody understands why it's been divided by .67. However, as mentioned before, one way or another the calculation of benefit, or of the pre-tax equivalent benefit, is based on the New Zealand tax rate irrespective of the mistake which Mr Todd appears to have made.

The next point is a more substantive one. I'll presently go back to Professor Choudhry's evidence. The next point is the justification for viewing the 149 million payment channelled via Deutsche Bank to Frucor as being an equity injection.

Our position is that first of all they get shares at the end, so it looks like equity. The second point is that whether it is an injection for or a payment for shares or whether it is just capital. It is as a matter of substance zero cost funding when you look at the arrangement as a whole, because the coupon which was paid to obtain goes wholly to discharge debt and interest on the 55. Perhaps to have as a ready note for an articulation of why the Commissioner sees this as equity, I could take you to, it's two paragraphs in the Commissioner's statement of position, which is in volume 3D under tab 34. It starts at page 304.0700.

WILLIAM YOUNG J:
Sorry, you're going to have to give me – so whereabouts?

MR SMITH QC:
It's under tab 34 of the exhibits volume 3D.

WILLIAM YOUNG J:
All right, okay.

MR SMITH QC:
304.0700, and the relevant passage is on page 0710, two paragraphs, 57 and 58. So: "The taxpayer's SOP debates the Commissioner's contention that it is reasonable to view the $149 million consideration paid –

WINKELMANN CJ:
So it's 701, second page in?

MR SMITH QC:
710, I do apologise, paragraph 57 and 58.

WINKELMANN CJ:
It's just as well, because 701 was upside down.

MR SMITH QC:

So 57: “The taxpayer’s SOP debates the Commissioner’s contention,” that it is: “an equity injection in substance, albeit that FHNZ receives the shares in five years’ time. The taxpayer appears to have two problems with the Commissioner’s view. Firstly, it appears to FHNZ that the Commissioner has focused on the position of Danone Asia as the recipient of the shares rather than FHNZ as the issuer, and it also ignores the five year delay between the funding injection and the share issue. Reduced to its essence, under an arrangement where the shares are issued by a subsidiary in return for funding from its parent, it is reasonable to view this as an equity injection from the parent. Further, in reality there is no economic difference between a share issue now or in five years’ time when the share issuer is a wholly owned subsidiary and the shares are issued to its parent. While the timing of the funding is economically important to both parties, the shares issued in consideration for that funding have no economic effect on either party, given the wholly owned nature of the relationship. Where there is no difference economically between the two share issue events, it seems reasonable to view the economic reality as an equity injection on the date the funding is provided. The Commissioner –

GLAZEBROOK J:

The argument is you could never have a convertible note, a hybrid, between wholly owned subsidiaries.

MR SMITH QC:

Well you could.

GLAZEBROOK J:

So you would say exactly the same thing in New Zealand presumably between two wholly owned subsidiaries that you couldn’t have a hybrid note?

MR SMITH QC:

Well, first of all, one would think that you would have a more simple structure.

GLAZEBROOK J:
I'm sorry.

MR SMITH QC:
First of all, one would think you would have a more simple structure, but you could have a hybrid note. The difference being two things. The payments in the interim would have to be interest and secondly, if it had always been the intention to take shares at the end, then there would be an issue of tax avoidance.

GLAZEBROOK J:
An issue of what?

MR SMITH QC:
Of tax avoidance, if it had always been the intention. I mean, for example, it has been –

GLAZEBROOK J:
But you would have a mandatory conversion convertible note and there's no question of intention there?

MR SMITH QC:
Oh well, if there is no question of intention, that's correct.

GLAZEBROOK J:
But I'm saying your argument is basically you can't have a hybrid instrument between a parent and a subsidiary, a wholly owned subsidiary?

WINKELMANN CJ:
It's not you can't have it, it's just what the tax effect of it is.

MR SMITH QC:
You can have it but what you can't do pursuant to it, if it has the particular curlicue that this one had which it wouldn't one would think, is to in economic substance pay off debt.

GLAZEBROOK J:

Oh no, I can understand that argument. I just don't understand the other argument.

MR SMITH QC:

All I'm saying is we can't have this one.

GLAZEBROOK J:

Okay, that's fine. Okay, that's fine. I can totally understand that argument.

MR SMITH QC:

So where I was before the break was in Mr Choudhry's evidence and I was going to go to 32 where under a heading he addresses the commercial and economic effects including the benefits of using the convertible note and the forward purchase. In 32 he says –

GLAZEBROOK J:

That's his paragraph 32?

MR SMITH QC:

His paragraph 32. I'm sorry, did I accidentally let you put away Mr Choudhry's evidence?

GLAZEBROOK J:

Yes.

MR SMITH QC:

I'm very sorry. Page 0190.

GLAZEBROOK J:

I'm sure there must actually be an easier way of tabulating these things.

MR SMITH QC:

Anyway at paragraph 32, looking at the question of why the note isn't conventional is that there's no prospect of the shares leaving Danone Group.

So 32 looked at in the evidence of Mr Choudhry, looked at as a standalone transaction FHNZ benefits from obtaining medium-term funding at an interest rate below that which it would be expected to pay if borrowed on the capital markets as a standalone legal entity, ie, not part of the Danone Group. FHNZ was unrated at the time so one would expect a five year bond that issued at the same time to exhibit a coupon higher than 6.5%. Of course, it would not be feasible for Frucor to issue a standalone convertible bond because it was a wholly owned subsidiary of DAP and not listed so no external investor would be interested in such a note unless the parent was willing to reduce its 100% shareholding which I understand is specifically not the case and it plainly was.

Then next in his evidence he says from, and I will go to the passage presently, but he says that: "From Deutsche Bank's point of view, it's entirely unconventional. The benefit is a fee."

GLAZEBROOK J:
What paragraph are you on now, sorry?

MR SMITH QC:
I'm going to, I'm just summarising, going to go to paragraph 40 and then 43 and then 44. But he says: "The benefit is the relationship upside with the client." So 40, at the bottom of page 192: "This transaction was arranged by the structured capital market business line of Deutsche Bank AG in different parts of the world in conjunction with the debt capital market teams and not the corporate banking business of the bank. This distinction is significant. Conventional corporate banking generates return by lending money to corporate customers, in other words, the bank makes use of its balance sheet when lending money to clients. The other business lines generate their returns by levying fees for the advisory work they undertake. There is no use of the balance sheet. There was a loan made by DBNZ in this transaction but the only element from the business returns analysis is the arrangement fee. This is the benefit of the deal from DBNZ perspective. There was also a soft benefit in that it was customer advisory business in an investment bank.

Anything that advances and/or deepens the customer relationship is a soft benefit."

Then 43: "It appears DBNZ generated no funding on its P&L. The transaction structure shows the coupon receivables to DBNZ structured capital markets were passed through to DBNZ treasury."

Paragraph 3.6 states: "DBNZ treasury swapped a Euro deposit using FX swap to convert NZD receivables into Euro receivables at the EURIBOR minus seven basis points. This suggests the hedge transaction very close to Deutsche Bank AG's average cost of funds which at the time would be approximately LIBOR flat or LIBOR minus ERGO." No funding gain on the transaction. The fee is the only thing in it.

And then 44 an unusual feature of the transaction, he just goes on to say that there is a guarantee, or in fact two guarantees, but contrary to the usual position, it's not the borrower who pays for it but the lender itself.

The next point emerging from Professor Choudhry's evidence was that there was no chance of there being cash from Frucor because to do so meant that there would be the gross-up and he, at his paragraph 48, he just describes conveniently the effect of clause 3.4 in the forward purchase deed. I don't need to take you through that.

Then again at 51 no chance that there would not be a conversion to shares, but then he has a number of paragraphs on the derivation of the coupon rate and what you might draw from that. Those paragraphs are firstly 35 and then I will go to 60, 61, 62. 35: "I note that as detailed in an email from Scott Burridge to Pierre-Andre Terisse on the 7th of March the 55 million of net lending from DBNZ had nothing to do with DBNZ's lending capacity and nothing to do with financing needs of FHNZ. See further discussion in paragraph 62 below."

Then in 60, we will come onto 62, he has a section heading “The coupon rate of the note.” “The coupon rate of the note is a market rate that is referenced off the NZD swap curve,” which he says is a bit volatile for the time. “The spread of 30 basis points over swaps appears to be as expected for an A1, A+ (borrower) which this bond represented and in effect compared with other corporate bond issues in New Zealand at the time. However, this is not how the coupon rate on a convertible note would normally be derived. Typically the issuer will be rated and it’s equity will be listed on an exchange, hence it has a transparent share price. The baseline coupon is what would be payable if the bond was a plain vanilla fixed coupon, fixed term bond. This will be spread over the swap rate commensurate with its credit rating and what it’s peers or similar rating are currently paying. Adjustment based on what the coupon and the underwriter thinks it can place the bond at, that is what the demand for the note is from the investors and clients.” Of course there are no investors and no clients here. “The coupon will then be adjusted downwards based on the value of the embedded option in the bond and this value will be calculated in basis points and will be a function primarily of the volatility of the share price and the time to maturity or conversion. The higher the value of the option which in essence means the more volatile the share price and the longer the time to maturity the lower the level of the baseline coupon the bond will be. Supply and demand considerations of potential investors will still apply at this point as the issuer and its underwriters set the final bond coupon.”

Then 62: “The notional amount of the note was arrived at in what can only be described as an unorthodox and not market conventional fashion, implying strongly that it had nothing to do with the medium-term corporate funding requirements of FHNZ. That’s illustrated by an email dated the 7th of March from Scott Burridge to P-Andre Terisse where bullet point (1),” and that’s the exhibit number which I’ve taken you to is in the margin, “where bullet point (1) states that once the DB swaps desk in London advises the five-year New Zealand dollar coupon the present value of five years’ worth of coupons a this rate will be added to the forward purchase deed payment of 149, giving a notional 204 million. That the face value of the convertible note has been

derived through this process is further illustrated by the fact that the principal amount is a very exact number," and it gives it. "This is not commonly how conventional bond issue notional amounts, convertible or otherwise, are arrived at in the market. Note also that the coupon on the bond is essentially what was required to generate bond coupon payments that aggregated to the five-year amortizing loan."

He then deals with the issue of circularity in 69, 70, 71. 69, "The artificiality of the transaction with respect to being a genuine corporate finance convertible bond financing scheme and the embedded equity interest for this investor is apparent when one observes the circularity of the use of funds., Ordinarily, an offer document for a convertible bond issue would state the purpose for which the funder derived would be used. Typically the use may be for a capital project or some other specific purpose to strengthen the company in a way that responds to the investors' desire to be satisfied," and then on: "The issuer may not be required as a matter of contract to use the funds for that stated purpose," provided the prospectus isn't misleading.

70, "However FHNZ did not use the funds raised for any stated conventional capital investment purposes, which is the most common reason why a corporate issues debt in this form. The funds were not used, for example, to invest in new plant or machinery or to develop a new product line or fund a marketing campaign. DAP in effect gifts a substantial part of the funds raised, via the FPD," or DBNZ, "to enable FHNZ to buy back shares and repay an earlier inter-company loan. In essence, the funds went back DAP 60 plus the 144. This is not a funding transaction. I do not mean that this deal did not lead to funding for the New Zealand taxpayer. Clearly, some funding did come to FHNZ. Rather, the deal would in my experience likely not have taken place without the associated tax relief on the debt interest, which optically appears to be 66 million. The deal was designed to generate this debt interest on which tax relief could be claimed, and the high arrangement fee was likely viewed as acceptable, given the expected tax benefit. In my view, this transaction would not stand on its own as a funding transaction. The notional amount is unrelated to the financing needs of the issuer and the bond

features clauses and terms that would render it unsellable in anything other than this particular arrangement, which was designed to generate debt interest cash flows on which tax relief could be claimed. That is not a driver of a genuine funding transaction.

Now the next issue is – well, he carried on and summarises to that effect also in paragraph 75 to 77.

The next issue concerning Professor Choudhry is that during the course of trial, and I think during the appeals, there has been reliance on the evidence of the sole witness, Mr Marcello, called by the taxpayer. And Mr Marcello said, and it was advanced in submission, that exactly the same effect could have been reached by funding the New Zealand subsidiary by means of a syndicated loan instead. Mr Choudhry sets out to reply to that contention in his evidence in paragraph 79 onwards. So he starts with Mr Marcello's evidence at paragraph 78 and then makes specific comments in relation to that. For example, in 81 he refers to Mr Marcello's evidence at paragraph 69 which is the evidence in which Mr Marcello said: "Well, we could've done this by a syndicated loan so it would've been fine."

Mr Marcello's evidence does not recognise that the same effect, retention of funds, could've been achieved by a straight equity injection or a preference share issue. The former and some forms of the latter of which would also have enabled FHNZ to reduce operational cash flow requirements as no coupons would've been payable. The final transaction was not the only way to achieve this result should it have been a genuine aim of the deal. Had the group policy been one of increasing debt in New Zealand, then again the orthodox approach would've been an inter-company loan at arm's length interest rate or a bank loan, or syndicated bank loan between FHNZ or its relationship banks. Now, that was the general thrust of what Mr Marcello said. Sorry, I think his name is pronounced Marcello and the general thrust of what Mr Choudhry had to say in response. All this was put to Mr Marcello in cross-examination and the passages appear in the evidence bundle under,

which is the second of those, under tab, sorry the first of the evidence bundles under tab 3 and it begins at 201.0070.

WILLIAM YOUNG J:
201, sorry?

MR SMITH QC:
This is the evidence volume 2A.

WILLIAM YOUNG J:
Yes, I've got that.

MR SMITH QC:
Sorry, 0070 it starts under tab 3.

WINKELMANN CJ:
The document side of my screen is completely frozen which is going to make it difficult for me to follow.

MR SMITH QC:
I wonder if I could just give you, subject to it not being marked which is an undertaking here.

WINKELMANN CJ:
Yes, because it will much better than having to retire and try and fix this up.

MR SMITH QC:
There are markings in red if your Honour pleases but they are agreed corrections.

WINKELMANN CJ:
Thanks.

MR SMITH QC:

There's nothing controversial about them. So it's 0070. It's on intrinsic page 45 of the notes of evidence. So, I'm referring there at line 8 with the question to paragraph 81 of Mr Choudhry's evidence which I'm in the process of putting to Mr Marcello and that paragraph of course refers to 69 just as I've said and much of the cross-examination, for the benefit of the record, repeats what is said in the evidence, so it should be reasonably intelligible from the cross-examination without going to many other documents.

Question: "Paragraph 81 he refers to paragraph 69 of your evidence. Would you just go to your paragraph 69? And there you've said, 'One of the documented aspects of convertible note transaction resulted in retention of funds in the New Zealand group,' and you refer to a document saying – "

GLAZEBROOK J:

I'm sorry, I've just lost you now.

MR SMITH QC:

You're on the page I think your Honour, but it's lines 7 onwards, 8 onwards.

GLAZEBROOK J:

That's 0070, is that right?

MR SMITH QC:

0070. So it should begin with, the passage I have should begin with paragraph 81.

GLAZEBROOK J:

Yes.

MR SMITH QC:

Question: "Paragraph 81 he refers to paragraph 69 of your evidence, would you just go to your paragraph 69? And there you've said, 'One of the documented aspects of convertible note transaction resulted in retention of

funds in the New Zealand group,' and you refer to a document saying that you've got that paragraph there haven't you?"

Answer: "Yes."

Question: "And so in response to that, Mr Choudhry proposes to say," bearing in mind we haven't yet called him: "Paragraph 69 in Mr Marcello's evidence does not recognise that the same effect could have been achieved by a straight equity injection or preference share issue, the former and some issues of the latter which would also have enabled FHNZ to reduce operational cash flow… Do you agree with that statement in the first sentence of his paragraph 81?"

Answer: "To achieve the benefits of my brief, paragraph 69, of having funds available – "

Question: "Yes."

Answer: "– that is correct by equity of preferred shares it's achieved."

Question: "He then goes on to say, 'had the group,' this is the last sentence in 81, 'Had the group policy been one of increasing debt in New Zealand then again the orthodox approach would have been an inter-company loan at arm's length interest rate or a bank loan or syndicated bank loan for FHNZ and its relationship banks.' So if it's retention of funds in New Zealand, a bank loan or a syndicated loan by itself with no structuring would have achieved that, would it not?"

Answer: "Alternative arrangements, debt financing, could be appropriate."

Then over the page:

Question: "If you go to your paragraph 71, an internal Danone Group memorandum you're referring to, headed up 'New Zealand financing' recognised the possibility of a greater capital base at the maturity of the transaction," and he's asked, "and you give a documentary reference for that, and in relation to that Mr Choudhry will say, 'In respect to paragraph 71, the final form of the financing transaction was by no means the only way that this stated desired aim could be realised,' you'd agree with that, I take it?"

Answer: "Correct."

The over some pages to page 0073 by line 21:

Question: “Can you go please to your paragraph 77?”
Answer: “Of my brief?”
Question: “Yes, your brief, and you're there referring to a lower fixed interest rate funding for FHNZ, aren’t you, paragraph 76 and 77?”
Answer: “It’s speaking of a fixed rate medium term financing.”
Question: “In relation to 76 and 77 at 84 of Mr Choudhry, he proposes to say, ‘The benefit identified by Mr Marcello,’ you, ‘in this paragraph, ie, five year funding at a fixed interest rate over term, could have been obtained easily using an alternative vanilla fixed rate financing structure,’ would you agree with that?” “I agree with that for the effect of having a fixed rate medium term financing.”

Then over the page on page 0075, line 8:
Question: “Could you please go to your statement of evidence, paragraph 77? There you refer to an internal Danone Group memorandum with a citation from that memorandum, don’t you?”
“Yes.”
“And then at the bottom of that citation or, sorry, the quote from the memorandum, you say, ‘Our international treasury,’ not, you say, you refer to that note as having said, ‘Our international treasury confirms that a financing through a bilateral bank would have been more expensive,’ is that what the note says?”
“Yes.”
“Do I understand that in this case, as in other parts of your evidence, you're simply recording what the note said, you're not purporting to say yourself whether that’s true?”

GLAZEBROOK J:
I’m sorry, I think I have lost you again. I keep finding bits of it but I’m not entirely sure where you are.

MR SMITH QC:
Page 0075, beginning at line 8, question: “Could you go please,” and at the bottom or halfway down the page I’m putting in: “Do I understand that in this

case, as in other parts of your evidence, you're simply recording what the note said, you're not purporting to say yourself whether that's true?"

Now, just pausing there for a moment, this represented a particular feature of Mr Marcello's evidence which was that Mr Marcello wasn't present at the time of the transaction being entered into and nor did he play any part in that transaction being entered into. He was produced as a witness simply to produce documents and make comments by way of what is described I think in the *Westpac Banking Corp v Commissioner of Inland Revenue* (2009) 24 NZTC 23,834 (HC) decision by Justice Harrison as a linking narrative, that is to say the evidence shouldn't amount to much more than that if it's given by a person who hasn't been there and in any event seeks to contradict the primary record which is in the documents. But what he was of use for was, as we'll see shortly, to confirm that if we were looking at legitimate lines of funding there was precisely no reason why Frucor in New Zealand couldn't have obtained funding by the means described by Professor Choudhry, the only difference being is that it wouldn't have been as tax-effective as the arrangement that he entered into.

So the top of page 0076 he's looking at again Mr Choudhry's evidence and also he's looking at a document which I took you to which is under tab 66 which is a note from Mr Terisse. So, that's from Mr Terisse the 11th of March 2003: "See that, yes."

Question: "And there he has said apparently that the financing cost is extremely attractive for New Zealand dollar financing."

He says: "That's what it says."

"Looking at that Mr Choudhry says about that, one thing he says in his paragraph 87 is that Mr Terisse appears to be referring to the after tax cost of funding. Would you agree with that? Perhaps you'd also look at his paragraph 88 just to give you the whole picture."

Answer: "In combination with my brief's paragraphs 79 and 80 it does give reference to the after tax benefits of New Zealand dollar."

Question: "You're confirming that that appears to be what Mr Terisse was talking about and you're prepared to agree that Mr Choudhry is right?"

Answer: "That's correct."
Question: "So, would you then please go to your 81. Again, that's an internal Frucor memorandum and there is supposedly a key commercial driver, it said – I should say that in his memorandum there's a key commercial driver of the transactions which are securing the fixed term funding at a lower cost of borrowing under a convertible note facility than a more expensive syndicated loan structure. That's what the note says, isn't it?"
Answer: "Correct."
Question: "And you see that Mr Choudhry has commented on that in his paragraph 89, you'll see that. I will just give you a chance to read it."
Answer: "That's right, he highlights that the quote appears to be in reference to the after tax benefits, that's correct."
Question: "And you see that he is saying that unless the quote at 81 of your brief of evidence is talking about the after tax cost of funding he doesn't agree with the statement that the cost of borrowing under the note facility was lower than the syndicated loan structure and he goes on to say why, -you see that?"
Answer: "That's what he says here, yes."
Question: "Do you agree or disagree with Mr Choudhry?"
Answer: "I agree with that statement."

So, and there is more of this over the page. We have it from, for what it is worth, from somebody who's a witness from Frucor simply saying that the tax effect was the purpose of the arrangement.

The points I want to draw from Mr Choudhry's evidence are as follows. In terms of the considerations in *Ben Nevis*, in my submission, there are a number of artificial and contrived features by which the arrangement through its structure brings about what on the face of the convertible note alone is an inherent – that interest charge, that's to say compliance with the specific provisions. So they include the lack of a volatility play. There's no upside on the convertible note. There is in fact no lower rate of interest. There's no option but to convert to shares. There's no value to DBNZ in the shares.

WINKELMANN CJ:

Just a little bit slower.

MR SMITH QC:

I'm very sorry.

WINKELMANN CJ:

That's all right, just a little bit slower. No option but to convert to shares.

GLAZEBROOK J:

What was the first point because I missed that one?

MR SMITH QC:

No option but to convert to shares.

GLAZEBROOK J:

No, no, the –

WINKELMANN CJ:

The lack of a volatility play.

MR SMITH QC:

I will start again. No volatility play, no upside. Secondly, there is no lower rate.

GLAZEBROOK J:

What do you mean by that?

MR SMITH QC:

Well, he says that when you buy an ordinary convertible note then embedded in the note, as we know, is an option, but there is a price to pay for the option and that's to say which is the cost of the embedded option of conversion at the election if it's an optionable conversion or convertible note by the investor. So, an ordinary conventional convertible note always has that embedded option to take advantage of a play should one be available on volatility and it

just doesn't possess it and he's very clear about that in the opening parts of his evidence. In fact, he said he's never seen a convertible note structure which doesn't possess this feature other than one which is tax driven.

Secondly, no lower rate of interest, which was what you would expect for a conventional convertible note. Thirdly, no option but to convert to shares which seems not to be in dispute. Fourth, no value to DBNZ in the shares. Fifth, a rate and face value which is artificially determined without regard to funding needs so purely to bring about repayment of DBNZ's loan while appearing to pay interest on the whole face value of the note. Next, no point or value over a syndicated loan as their own witness has agreed unless the point is tax relief.

WINKELMANN CJ:
Can I just ask you, there's no value to DBNZ in the shares?

MR SMITH QC:
Yes, no value to DBNZ in the shares. They can't keep them and woe betide them if they tried for the reason we've gone through.

I just wanted to deal, this is a part of, the next thing I was going to go onto being mindful of time is counterfactuals and counteraction.

WILLIAM YOUNG J:
Before you do, can I just ask you a question about something I don't understand? The Court of Appeal judgment, if you look paras 88 to 90?

MR SMITH QC:
Yes.

WILLIAM YOUNG J:
Reads $149 million as the starting point from which all other figures are derived.

MR SMITH QC:
Yes.

WILLIAM YOUNG J:
And in 88 it said that this equated, represented 147 million to repay the loan from Danone Finance and there's also, in the next paragraph, $2 million for the fee in para 89?

MR SMITH QC:
Yes.

WILLIAM YOUNG J:
Now, just going back to the wiring diagram that Mr McKay relied on, have you got that to hand?

MR SMITH QC:
Yes, I have got it, thank you.

WILLIAM YOUNG J:
Can I just preface what I'm about to say by recognising that the figures in this case tended to be a bit of a moveable feast reflecting presumably currency movements and intermediate transactions, but this suggests $144 million was used to repay Danone Finance, not 147?

MR SMITH QC:
Yes, and I understand that is the right figure. I must say when I saw that $147 million figure in Court of Appeal's paragraph 88 just now I can't rationalise why that's there, if that's your question.

WILLIAM YOUNG J:
I mean the figures that add up to me and equate are the 89 million from BNP and the 55 million from Deutsche Bank lining up with the 144 million owed to Danone Finance. That still however leaves unexplained why the $149 million figure which of course is close, $5 million doesn't matter, how that's been

chosen because the documents you've taken us to suggests that that is the starting point for all the other calculations?

MR SMITH QC:
I simply can't explain it, but I do see that over the page in paragraph 90 they have got 149 at the top. The correct figure is 149.

WILLIAM YOUNG J:
Yes, okay, it may be that the Court of Appeal is right but it's an earlier stage and it refers to figures at an earlier stage in the process.

MR SMITH QC:
At a point 149 became 149 and stayed 149. I can't exclude the possibility offhand that there was a different figure earlier on.

WILLIAM YOUNG J:
But since 149 in reality is what I regard as puff of smoke money, it's hard to see why it was treated as a, this is an open not a closed question, it's hard to see why it would be chosen because it disappears.

MR SMITH QC:
Well, the answer that might suggest itself is that twofold. First of all, there might have been an internal reason which we're not, this makes no difference to our position, an internal reason for Danone why they wanted to use that number. The second point is that whatever the number was they did need a number from which to derivate the present value, a starting point, and that's what was chosen.

So I wanted to go to this next issue of counterfactual and reconstruction, or counteraction. This is my friend's submissions at paragraphs 94 to 110 and it concerns a contention that there is an obligation to take into account a counterfactual scenario in (a) deciding whether or not there was tax avoidance and in deciding what should be done by way of counteraction or reconstruction under section BG 1 and GB 1 and I rather apprehend from my

friend's submissions, although I don't recall that he spent a great deal of time on his feet yesterday that although the notion of counterfactuals was put forward without success in *Alesco* and might be being put forward in this case, in *Alesco* it was put forward as a defence to a BG 1 analysis which would arrive at the conclusion of tax avoidance whereas in this case it has put forward more and I apprehend possibly entirely at the so-called reconstruction or counteraction stage. I will come to what it is that I apprehend that is being said more precisely in a second, but first of all we start with section BG 1 which envisages reconstruction which may be done by counteraction of the tax advantages under part G and it may be as well just to have part G open which is under tab 4 of the first volume. You were taken to it yesterday. So, GB 1(1), I hope I'm not ahead.

GLAZEBROOK J:
I'm sorry, could you just wait a moment.

WINKELMANN CJ:
What section are you taking us to because I've got some. Even though my computer is not working I can look at the physical forms.

MR SMITH QC:
In particular GB 1 and part G. So GB 1.

GLAZEBROOK J:
I just don't seem to have the authorities in any sensible place as far as I can make out.

MR SMITH QC:
I wouldn't want to bother you with it unless I thought it was important to eyeball it for the purposes of this argument.

GLAZEBROOK J:
It might be easier just getting up though.

MR SMITH QC:

Can I just hand you up?

WINKELMANN CJ:

You could just search in Legislation New Zealand if it's easier.

GLAZEBROOK J:

Yes, I know, that is what I was going to do.

MR SMITH QC:

Is it helpful for the time being if I hand up my unmarked copy?

WINKELMANN CJ:

I think we can just find it on Legislation New Zealand. It's easy enough.

MR SMITH QC:

The common resort in defiance of all databases which we pay for. I will wait until you there if your Honour pleases. I am being asked to make sure in 2004.

WINKELMANN CJ:

GB 1?

MR SMITH QC:

GB 1 gives a general power of adjustment to counteract and the powers exercisable in respect of any person if we see in the third line affected by the arrangement, so the requirement is just that there is a person, it could be anybody, who is affected by the arrangement and as we see, I'm not going to take you to these cases, but *Miller* and also *Wire Supplies*. I think your Honour Justice Glazebrook might be familiar with the latter case. Any person is not limited to the taxpayer initially under scrutiny. So what the Commissioner has done here is that she has simply counteracted as opposed to taking a more complicated reconstructive approach and so although there was a reference to reconstruction in BG 1, that is envisaged certainly in GB 1

but what is also envisaged in GB 1 is simple counteraction which is what the Commissioner has done. She has simply adjusted the deductions claim downwards by removing the principal payment portion approximately 55 million. We understand that Frucor's argument is that a counterfactual should be used but unlike in *Alesco*, this argument in this appeal finds its expression in what they call the reconstruction, or more aptly here, the counteraction process as opposed to the exercise of determining if there is a tax avoidance arrangement.

So the counterfactual is said to arise under GB 1, or, if it was used by the Commissioner under GB 1(1)(a) and our first point is that putting aside anything else, because this was a simple case of counteraction, all the Commissioner did was to proceed under GB 1 and did not have resort to GB 1(1)(a), or GB 1 (1)(b). The second point is that nor was the Commissioner required to proceed under GB 1(1)(a) or (b).

The next point is that as was seen in the cases of *Miller* and *Wire Supplies*, again, I'm not going to take you to them but they're in the supplementary bundle filed more recently for the Commissioner. GB 1(1)(a) is intended to allow the Commissioner to assess as if the arrangement had not been entered into including to concluded that in that event a person, a person, not necessarily the original taxpayer in view, would have had assessible income just as was seen in *Miller* for example. So it's intended to have application to more complicated reassessments where, for instance, a simple counteraction may leave the Commissioner with an unpaid assessment and you may all recall that in *Miller*, for example, which I think like *Wire Supplies* was one of the Russell Construction's arrangements. In *Miller* there had been a process where there were a number of companies which were invested in and they were profitable until presented by Mr Miller with substantial invoices for admin services which were paid and the amounts paid which were substantial enough to render the companies not profitable, were, after that, returned as capital, so a reasonably crude device which was used.

So as I understand it, what is being said here is that the Commissioner shouldn't have proceeded under GB 1(1) to simply counteract but should have proceeded under GB 1(1)(a) because GB 1(1)(a) provides that: "The Commissioner may have regard to such amounts of assessable income deductions and available net losses as in the Commissioner's opinion that person would have or might be expected to have, or would have or likely had if that arrangement had not been entered into." And so it's being put forward that another arrangement would have been entered into. It's the equivalent here of hypothesising we say the correct equivalent of hypothesising the arrangement had not been entered into would be to reconstruct, if you were going to reconstruct, as if, wholly irrespective of the convertible note deed and the forward purchase deed, Frucor did not undertake the further step which was envisaged under those documents of claiming the deductions for the full $66 million, and that would have, as it happens, exactly the same effect as counteracting so why bother to enter into that hypothetical analysis? The Commissioner didn't.

WINKELMANN CJ:

Is your answer one of statutory interpretation to this? Because I'm just finding your argument complex. I would have thought there was an argument, a simple argument available to you, that's GB 1(1)(a), doesn't contemplate what Mr McKay is talking about because it simply talks about as if the arrangement had not been made or entered into, not as if another arrangement had been made or entered into.

MR SMITH QC:

What my friend says it contemplates is that would mean that you'd have to consider what would have been the status quo.

WINKELMANN CJ:

I know. But my point stands that that's not what the subsection says. Isn't that what we have to do, look at what the section says?

MR SMITH QC:

Well, that is *an* answer, but if I'm wrong on that, if I'm proven to be wrong on that in the fullness of time, two points. First of all, any counterfactual which you did come up with would have to be a reasonable one. The only reasonable, well, *a* reasonable counterfactual, is that you might have entered into this arrangement but you didn't fulfil it, simply by dint of not claiming the deductions, in the event, not claiming the deductions which the arrangement envisaged that you might. But apart from that, we –

WINKELMANN CJ:

Can you just repeat that argument again? I'm sorry to be dim, but I didn't follow it.

MR SMITH QC:

Well, it's a question of, this boils down to the question of precisely what counterfactual it is –

WINKELMANN CJ:

If any.

MR SMITH QC:

– that the taxpayer is saying should have been taken into account. So, I accept that on the face of the section there's no reference to the taking into account of a counterfactual as such, and that is a point, absolutely, and it may be enough to dismiss the argument on those terms. But if you don't, and it was thought that there is a need to look at a counterfactual, only because the section says, well, the Commissioner can look at what would have happened in all likelihood if the arrangement had not been entered into. You have to know what would have happened if the arrangement had not been entered into. And in this case we don't know. The only reasonable counterfactual is that, although it had been entered into, the taxpayer in the event decided not to – take its tax positions and its returns by claiming those deductions. But apart from that we have precisely no idea what might have been the counterfactual, or there's no evidence suggesting what would have happened

or, if there is, it could only come from Mr Marcello, and that evidence is to the effect that there might have been a syndicated loan at an interest rate, in which case all of the payments of coupon or interest under that arrangement would have been interest and wouldn't have been subject to any purported ability to claim as a deduction.

WINKELMANN CJ:

Because here, if you just give that meaning a plain, if you give that a plain meaning, the Commissioner may, which is a discretionary language, have regard to – if the arrangement had not been made or entered into, if the arrangement's not made or entered into I suppose you're back in the land where…

MR SMITH QC:

You've got the debt.

WINKELMANN CJ:

Yes.

MR SMITH QC:

And you are claiming interest because it is interest, that's one –

WINKELMANN CJ:

And you'd say that's not what you want.

MR SMITH QC:

It's not what – my point is that in that event, whether I want it or not, it's not a reasonable counterfactual because they entered into an arrangement where they did claim deductions based other than on interest. So if we're to posit, the only reasonable counterfactual is where a taxpayer in this situation in the event thought the better of it and decided only to claim deductions on the interest portion. You can't claim as a counterfactual something which simply isn't the equivalent and, in any event, we have precisely no evidence which tells us what would have been in place but for this arrangement. The other

reason why we don't know that is because, as I mentioned at the beginning, in the template, the slideshow presentation which I took you to as the first document under tab 40 it does seem tolerably clear that the arrangement which was entered into was in view between Deutsche Bank and Danone from inception, so that was the only deal on the table in any event.

WILLIAM YOUNG J:
I haven't studied all the counterfactuals in any detail, but I would be surprised if any of them enabled what in substance was a loan to be repaid by what in law are tax deductible payments.

MR SMITH QC:
None of them do and if there is one, then we have not been apprised of that in any evidence. That takes me to 15 minutes past my allotted time and I will stop here and let my friend reply.

WINKELMANN CJ:
Thank you, Mr Smith.

MR L MCKAY:
Can I just take 30 seconds just to get my papers up on the podium?

WINKELMANN CJ:
Sure.

WILLIAM YOUNG J:
Mr McKay, while I'm thinking of it, do you know why the $149 million figure was the starting point forward calculation?

MR L MCKAY:
My understanding, Sir, is that, similar to my learned friends, after a time through what was almost a one year evolution of the details of the structure, after a time, the 149 million as DAP's forward purchase amount became more or less fixed and no, there is no background evidence to that, Sir, but it

became a number from which and through the process that my friend described, the amount of Deutsche Bank's New Zealand contribution to the overall 204, what became 204 million became calculated and he's described the swap rate process and similar that went through by Deutsche Bank. But no, I don't think we have any precise information on that, your Honour.

Your Honours, in terms of the reply, there are two elements of my learned friend's submissions that I don't intend or need to spend any material amount of time on. My friend yesterday and this morning took the Court through a significant number of the background documents authored for the most part by Deutsche Bank, authored in part by Group Danone, that's the French company or on limited occasions other Danone entities including DAP. There is no material dispute between the parties not only that obviously the documents exist or as to the contents of those documents, or as to the inferences that are to be drawn from them in terms of the current appeal.

The only point with reference to that process that my friend took you through, the only point that I would make about it is that my friend wasn't at every point entirely accurate, I would respectfully suggest, in indicating whether the precise document that he was taking you to was describing, can I call it, the Group Danone consolidated position, or the position of Frucor New Zealand as a separate legal entity and I'm not for a moment suggesting he misled you, but there were occasions when he gave you references, for example, to a net exposure on the part of the Danone group to Deutsche Bank of 55 million which is perfectly sensible and accurate on a Group Danone basis because Group Danone, as a consolidated entity, had an external liability through Frucor New Zealand of 204 million, but it also, on a consolidated basis, had an asset represented by its forward purchase price of 149 million to Deutsche Bank. So, yes, it is 55 million, but there can be and I will show you briefly in a moment, there is no suggestion that the 55 million description was intended to be and certainly is not an accurate description of the New Zealand entity's position. I think if I might just illustrate that by reference –

WINKELMANN CJ:

Can I just ask you one question? You say that there's no difference as to inference. Well, I take it that there is because in fact Mr Smith said that the inference to be drawn, in fact the explicit statements made in the documents showed that the purpose of the transaction was the tax advantage to be obtained in New Zealand.

MR L MCKAY:

Well, insofar as he derives that from the proposition that the papers that he took your Honours to were papers demonstrating a $55 million exposure on account of Frucor New Zealand's position, then I would say, with respect, that that is incorrect because those papers are unambiguous –

WILLIAM YOUNG J:

Sorry, Mr McKay, the tax advantage calculation, although I think wonky, are by reference to the New Zealand subsidiary's position.

MR L MCKAY:

The tax benefit or advantage calculations, certainly, your Honour, I don't disagree for a moment, are based upon the fact that the full 66 million interest that is payable by Frucor on the Deutsche Bank convertible note 204 million is deductible to it in circumstances –

WILLIAM YOUNG J:

Isn't that the crunching point though?

MR L MCKAY:

I'm sorry, Sir, in that case you know what I'm going to say, so I will defer to you.

WILLIAM YOUNG J:

But it seems to me it is the crunching point.

WINKELMANN CJ:

I don't know what he's saying.

MR L MCKAY:

Yes.

WILLIAM YOUNG J:

What do you say to that?

MR L MCKAY:

I say it is certainly a crunch point. The identification of whether there is a tax benefit or tax advantage to Frucor New Zealand from entering into this transaction is a crunch issue in this proceeding and to do that, Sir, we have to be a two point, to make, form a view on that, there are two relevant perspectives. The first of them, is there a tax benefit arising from taking deductions on debt that you have incurred and the answer is yes in the sense that a deduction will serve to reduce your New Zealand tax liability. Whether there is a group benefit from this overall arrangement or transaction depends entirely on whether that deduction is paid for, or has a cost, in another jurisdiction by reference to a tax liability on the receipt. Now, in circumstances where Frucor New Zealand –

WINKELMANN CJ:

Can I just ask you to repeat that sentence?

MR L MCKAY:

Yes.

WINKELMANN CJ:

You said: "On whether that deduction is paid for in another jurisdiction."

MR L MCKAY:

Yes, or has a tax cost in another jurisdiction in the form of taxable income.

WINKELMANN CJ:
All right, okay, got it.

MR L McKAY:
And the easy illustration of that, and this is the before proposition, this is the counterfactual, if we take the arrangement in place before the convertible note structure was effected, we know that there was 144 million, I think it started at 150 but by the time of the arrangement that floating facility had reduced to around 144. We know that that 144 million facility from Danone Finance bore interest at a floating market rate, so it complied with the transfer pricing rules. It also had to comply with thin cap because there was a 50/50 debt equity structure, and we know that interest paid on it was deductible. So certainly there's a New Zealand deduction, but as a matter of Mr Marcello's evidence and it shouldn't be surprising, that interest receipt was picked up as income by Danone Finance in France, and we don't know about the French tax rate but let's assume it's about the same. So the Group's position is going to be determined by a reference to a New Zealand deduction and by reference to French taxable income.

Now that is before arrangement position. What happens as the result of the arrangement? We know two things happen. One, there is an increase on the Frucor New Zealand tax balance sheet and financial balance sheet of the level of interest-bearing debt, the 144 million goes up to 204 million. So just pausing there. Is that BG1? No, it's not. That's not the basis upon which the Commissioner has invoked the provision. The Commissioner in this proceeding accepts that because the 204 million debt on the local balance sheet was within New Zealand's thin capitalisation rules, or was lower than the cap that those rules establish, then the Group, Danone Group, was entitled to see that increase in the local level of debt. What else is a consequence of the arrangement? Is the New Zealand deduction position affected? No, before the arrangement there was a deduction at a market rate on 144 million, now there's a deduction for 204 million but the Commissioner does not treat as BG1-able, if I can put it like that, that consequence, so the deduction position is not altered. What has altered?

WINKELMANN CJ:

Sorry, the deduction position has altered, hasn't it, if they were deducting interest of 144 and now you're just…

MR L McKAY:

Yes, it simply is, your Honour, that the Commissioner isn't taking exception to that. The Commissioner does not think that is BG1, that's not avoidance, because it all operates within New Zealand's thin capitalisation rules which overlay…

WINKELMANN CJ:

It doesn't apply avoidance to that but it applies avoidance to the wider transaction of which that's part?

MR L McKAY:

What it applies its avoidance to is the deductions that are taken by Frucor effectively on the 144 plus the 60, even though with reference to that 144 million component of the ongoing debt, the post-arrangement debt in Frucor New Zealand, before the arrangement was entered into no exception at all was taken or could be taken to it.

WILLIAM YOUNG J:

Well, it wasn't repaying DAP Finance principal and claiming a deduction for it. I mean, they're not apples and –

MR L McKAY:

No, it repaid it to Danone Finance…

WILLIAM YOUNG J:

Yes, but it could only claim a deduction for the interest –

MR L McKAY:

Yes.

WILLIAM YOUNG J:

– it couldn't claim a deduction for capital repayments.

MR L McKAY:

No, I agree with that, Sir. So when it bring in 204 million, when it increases its level of interest-bearing debt, its paying a market rate of interest on that 204, your Honour…

WILLIAM YOUNG J:

That's assuming that's a real way of looking at it. In fact it reduced its interest debt from 144 million to 55 million.

MR L McKAY:

No, the group did that, Sir. Frucor New Zealand Holdings did not do that. And with respect to the examples that you've given, albeit not only to me but also to my friend, involving the aggregation of the Paribas borrowing and the borrowing from Deutsche Bank, those certainly were not transactions, at least the first of those transactions, although it has a connection in a commercial sense in providing part of the source apparently of DAP's 149 million. It's not a transaction that touches the New Zealand bracket –

WILLIAM YOUNG J:

Pause there. It provides all the source. 89 million comes from BNP, 55 million comes from Deutsche Bank, 144 million goes back to Danone Finance. All the, the new money that comes in is from BNP and Deutsche Bank and it goes out to DAP.

MR L McKAY:

Sir, as they come in though – and I'm sorry, I'm testing your patience…

WILLIAM YOUNG J:

It's all on the same day, isn't it?

MR L McKAY:

Oh, yes, it is, Sir, yes, in the same way as – I'm sorry, I was going to say something silly like most major commercial transactions of course involve all the cashflows, all the legal arrangements, are being structured to occur on the same day. Sir –

WINKELMANN CJ:

So it's lunchtime.

MR L MCKAY:

Oh, yes, I'm sorry.

WINKELMANN CJ:

So are you mid-thought?

MR L MCKAY:

No, I'm still trying…

WINKELMANN CJ:

Or can we resume?

MR L MCKAY:

I was still going to take you back to a Pricewaterhouse document in accordance with the first of the points I was making. But, no, I would welcome an adjournment, thank you, your Honour.

COURT ADJOURNS: 1.02 PM

COURT RESUMES: 2.18 PM

MR L MCKAY:

It's convenient, if your Honours would agree for my learned friend Mr Smith to address you on an issue arising during his submissions for 30 seconds or so, if that's agreeable to the Court?

WINKELMANN CJ:

Yes.

MR SMITH QC:

This is something which we may have misled your Honour, I just want to correct something if I may.

WINKELMANN CJ:

Yes, go ahead.

MR SMITH QC:

Just very quickly, it arises from the discussion that was had principally –

GLAZEBROOK J:

Can you perhaps move in front of the microphone as well, please?

MR SMITH QC:

I wanted to give the impression I wasn't going to be long. It's just something that arises over the discussion of tab 67 which is the note between Mr Todd and Mr Pierre-Andre Terisse in relation to the pre-tax effective savings. It came under tab 67 and during the course of discussion I agreed with his Honour that the correct calculation would appear to be to use a multiplier of point 33 which produced the figure that I mentioned earlier after you've deducted the fee which is 18 million odd. However, just over the lunchbreak it occurs that that calculates the post-tax equivalent. What this calculation was intended to do was produce the pre-tax equivalent. So it's necessary to gross it up by taking into account the dividing factor of point 67 to make it larger as a pre-tax equivalent, but that's what we think it means, but in any event, the position remains that it concerns New Zealand tax either way.

WILLIAM YOUNG J:

I see, okay.

WINKELMANN CJ:

Thank you, Mr Smith. Mr McKay.

MR L MCKAY:

Thank you, thank you, your Honour. I do want to return though not immediately your Honours to the question of New Zealand tax benefits and I want to move from there to the question of reconstruction and the provenance and proper interpretation of section GB 1 which my friend has taken you to.

Before I get to that though however, there are just two or three small points that don't relate as such to section GB 1 that I had commenced to make a reply submission on before I moved onto the question and response to Justice Young's question of tax benefits and since I don't want for those points to be lost I will make them now in short order before returning to that GB 1 issue.

I had made the point when I first got on my feet, your Honours, that there is no real dispute at all between the parties as to the nature of the Deutsche Bank or the Danone Group documents that my friend took you through yesterday and in his first hour this morning and that the general burden of those documents from a group, that's the Danone group and a Deutsche Bank group standpoint was to focus upon the net exposure of 55 million that arises from this arrangement to the Danone group itself. I had made the point though that those documents are at every point distinguishing between the group position which as your Honours will recall includes both the gross liability of 204 million and the asset at the DAP level of 149 million on every occasion where the 55 million net liability is referred to and I would stress, however, the position is quite different with every document that talks about the position of Frucor New Zealand Holdings itself where everything is put in gross terms and I will take you very briefly to one of the documents that my friend referred to as he was going through that variety of documents. It's a document at tab 49 of the case on appeal and it concerns the PricewaterhouseCooper's according advice given to DAP, the Singaporean parent, the provider and the counterparty under the forward purchase

agreement. If I might briefly, I will come back to the microphone your Honour, if I might briefly just take you to that document, you will see that the parties –

WINKELMANN CJ:
Tab what, sorry, 49?

MR L MCKAY:
Yes, it is tab 49. It was a document that your Honours have had some exposure to or familiarity with through my friend. It's complicated a little by the fact that the party that we are calling, or I have called DAP, D-A-P, the Singaporean parent, is referred to in this advice as DHA, but they are the same entities. It's complicated a little too by the fact that DHNZ is Danone New Zealand which we've called in this proceeding Frucor. But the fact is that the accounting advice is giving advice on the appropriate accounting treatment in both cases.

It talks on its page 2 of the two phases of the transaction. Phase 1 being the issuance by Frucor or Danone Holdings New Zealand of its five year convertible bond. In phase 2, this is DAH, that is DAP the Singaporean parent, entering into a forward equity purchase agreement.

When it turns over the page to the accounting treatments, it looks first at the position of DHA or DAP and then secondly, at the subsidiary level Frucor New Zealand and it's comments with reference to the second entry, the subsidiary, the single entity level as DHNZ is only a party to phase 1, that's the convertible note, only the accounting impact of the issuance of convertible notes is considered. For phase 2, I interpolate the forward purchase, DHNZ is not a party to the agreement and hence no accounting impact to this phase is considered. It then sets out with reference to the appropriate financial standards the calculation of the financial liability to what we call Frucor New Zealand, or DHNZ, of its entry into the convertible note and you will see that on page 5 of the advice it gives the top two-thirds of its page, it gives the appropriate accounting entries for DHNZ and in every case they are gross with reference to the principal amount of the convertible note

and also the full amount of the in aggregate 66 million interest that became payable under it.

It then turns to its DHA or its DAP consolidation entries at the bottom of that page and it's in that context that the treatment at the consolidated level reflecting the asset as well as the 204 million liability is one that involves the treatment of the group's net exposure as being what became a $55 million loan with the necessity to take each interest payment and divide it into principal and interest components. Your Honours –

WINKELMANN CJ:
I think the bit I was attracted to in terms of understanding the economic substance which we're entitled to look at was the description on page 3 under the heading "1 DHA company level".

MR L MCKAY:
Yes, DHA being the Singaporean parent, yes, and that's consistent with the view that for the purposes of both DHA's preparation of its own accounts, but also the principles of consolidated financial accounting in circumstances where there is an obligation to consolidate the entities that sit below you and bring their assets and liabilities onto your own balance sheet. It's certainly from DAP's, or DHA's standpoint is substantively doing exactly that when it merges the liability and offsets the asset that it has.

WINKELMANN CJ:
And it says: "Although DHNZ has repurchased its shares from DHA, DHA has forward purchased these shares back via the forward agreement with DB?

MR L MCKAY:
Yes, I understand that to be a reference to the fact that of course as to 60 million, your Honour, the –

WINKELMANN CJ:
Because it's not entirely that neat, is it?

MR L MCKAY:

Not entirely?

WINKELMANN CJ:

That neat. It's not entirely circular on that point. It's only 60 million that's repurchased.

MR L MCKAY:

Oh, indeed, whereas the establishment equity as we saw, may not remember, was $150 million, so it was a partial repurchase. Given that the extent to which the balance sheet could be reconfigured in a greater debt amount introduced was limited. I mean New Zealand's thin capitalisation rules are sitting over the top of all of this, so although there was some headroom, not a limitless amount, your Honour.

The final point with reference to those Deutsche Bank and Danone group, or DAP documents is to remind your Honours if I respectfully might of the point that is made at paragraph 70 of the appellant's written submissions and this is that in the course of the High Court hearing Frucor went through all of the evidence, both, well that's documentary evidence before the Court, all of the documentary evidence before the Court and prepared a table for the consideration of Justice Muir that showed every description that had been given in any of these documents to the question of a net loan of 55 million and without exception, as is recorded in paragraph 70 of the written submission and is accepted by Justice Muir, all references to a net $55 million exposure were either Deutsche Bank documents, and that's not surprising because that was its exposure or Group Danone documents prepared on a consolidated financial accounting basis.

WILLIAM YOUNG J:

But are there any Frucor documents? Are there really many Frucor documents?

MR L MCKAY:

There are very few, I'm sorry, there are very few Frucor documents prior to the arrangement being entered into. They are group documents, or Deutsche Bank documents.

WILLIAM YOUNG J:

What about the documents that says: "Why did we do it," where does that come from?

MR L MCKAY:

That's a document and I think that's one of the ones where we know it's a Danone document of some description, but that, as I recall, Sir, and it's only a recollection, is an undated document with no known authorship. I will ask my friends.

WILLIAM YOUNG J:

But it must have been in the possession of Frucor?

MR L MCKAY:

Oh yes. Yes, I believe that was a Frucor discovered document.

WINKELMANN CJ:

Mr Smith said it was a document that Frucor filed with the Commissioner.

MR L MCKAY:

Yes. The other, the more, if I might say so, the other class of documents that are available that are Frucor documents are Frucor's financial statements. As we know, it is obliged to prepare annual financial statements under the Financial Reporting Act. It's obliged to have them audited and it's obliged for its auditors to say that those statements are prepared in accordance with either IFRS or the appropriate accounting standards and without exception they show the liability 204 million.

WILLIAM YOUNG J:

Well, they would of course.

MR L MCKAY:

That being the substance of Frucor New Zealand's entity position, Sir.

WILLIAM YOUNG J:

But am I right in assuming that the brains behind this were in Deutsche Bank and Danone and the Frucor people just did what they were told, people at the Frucor level?

MR L MCKAY:

Sir, well, the answer to that is yes because going back to my first reply to you, there are, to the best of my knowledge, no examples of any case where there is an input from a local Frucor person.

WINKELMANN CJ:

Well isn't that just because this is a standard holding company situation where the treasury and corporate affairs are managed offshore, significant corporate affairs?

MR L MCKAY:

Yes and certainly where the funding, that's both the debt funding and the equity funding come from. I think confirmation of that comes from the fact that, and I am speaking from recollection, but from recollection, my friend in cross-examination of Mr Stanley Marcello went through some of the cast, some of the active people involved from the Danone and the Deutsche Bank sides and it was identified either in a general or a specific sense that they were all offshore people. So, yes, I think that might well be the case in response to Justice Young's point that it is substantively correct that no one at the local level was involved which isn't surprising not only for the point that your Honour the Chief Justice made, but also because this is a refinancing. This is a decision that's going to be made offshore. This is a decision that's

going to be made in accordance with the group treasury view of what the balance sheet of the far flung members of the empire should look like.

Your Honours, the second of the points that I wanted to, preliminary points as it were that I wanted to stress relates to my friend's reliance, co-equal I think with his reliance upon Deutsche Bank and Danone documents with the evidence of Mr Choudhry and in particular, I beg your pardon, of Professor Choudhry and in particular Professor Choudhry's view of the arrangement as being either artificial or unusual, or certainly not involving an event, not involving in form or in function or in pricing a convertible note in a conventional sense and your Honours will have forgotten but I made the point yesterday in the course of my submissions, most of those points, or in fact all of them substantively of Professor Choudhry's are points of differentiation between what he calls a conventional convertible note and this particular convertible note are referable to the consideration that by conventional or convertible note to him, he means a third party arm's length arrangement. He means in the very situation that my friend read out from his evidence this morning the situation where a company has a capital need for somewhere between in Professor Choudhry was 100, 200 or $1 billion. It has a particular project in mind. It goes to its managers and it says: "How can we place participations in these convertible notes?" It's in that context.

WILLIAM YOUNG J:
Can you just, sorry, Mr McKay, why in ordinary circumstances and devoid of tax as a driver, why would a wholly owned subsidiary issue a convertible note to its parent company?

MR L MCKAY:
Because of Singaporean tax benefits, Sir.

WILLIAM YOUNG J:
Well, I said eliminating tax considerations.

MR L MCKAY:

It's impossible to eliminate tax considerations in an arrangement of this character when one of the goals is to increase the level of interest bearing debt in New Zealand and another of the goals is to benefit the group, not Frucor New Zealand, but the group, by having no income assessable on the other end. That's why you would issue a convertible note because the Singaporean tax advice is that unlike interest income which would be taxable, this wasn't.

WILLIAM YOUNG J:

Just pause there. Just so I understand this, just postulate a scenario where Frucor might have issued a note to Danone without, and you say it can't be done because tax is everywhere?

MR L MCKAY:

No, no, Sir, I'm not but I am saying –

WILLIAM YOUNG J:

Without tax as a primary –

MR L MCKAY:

Tax is very influential.

WILLIAM YOUNG J:

Sorry, without tax as a primary driver, why would Frucor issue a note to its parent?

MR L MCKAY:

Without the Singaporean tax benefit as a primary driver Frucor would probably not have issued this note.

WILLIAM YOUNG J;

But if it's just between Frucor and Danone, why would there be a capital profit?

MR L MCKAY:

Because Singapore, like New Zealand, treats entities that are Singaporean tax –

WILLIAM YOUNG J:

Yes, yes, but why would there be a capital profit? If Danone simply takes advance of $200 million, has the option to convert that to shares at the end of the term, why would that create a capital gain?

MR L MCKAY:

It would create a capital gain because the other reality of the world apart from tax is the requirements of financial accounting and we know in broad terms from that Pricewaterhouse advice that DAP as the parent of Frucor New Zealand has to financially account for its involvement in the transaction and its involvement in this transaction by way of a forward purchase of shares –

WILLIAM YOUNG J:

Leave aside the forward purchase of shares. Just assume Frucor and Danone.

WINKELMANN CJ:

We've cut Deutsche Bank out.

WILLIAM YOUNG J:

Cut Deutsche Bank out of it. Why would Frucor issue a convertible note to Danone?

MR L MCKAY:

Frucor would issue a convertible note to Danone probably only in circumstances where it did not have a concern with the New Zealand, any New Zealand tax deduction that it would be foregoing by not borrowing in an overtly debt form.

WILLIAM YOUNG J:

But that would be a debt form.

MR L MCKAY:

Well, in those circumstances it's almost, well, it is certain, it's only rational that if it was in a debt form the parties would have agreed to a lowest price for the future value of the shares on the basis that otherwise Frucor New Zealand would be foregoing the interest deduction that it has available to it under its Danone Finance facility.

WILLIAM YOUNG J:

So why would it do it? You're suggesting that this is an orthodox transaction as between a subsidiary and a parent. I can't see why that would be so unless there's a third party involved.

MR L MCKAY:

It would do it, Sir, for the most, and I'm sorry, I don't want to trivialise your Honour's questions, it would do it for the obvious reason that in its before arrangement situation it's entitled to an interest deduction on its debt financing from Danone Finance. It would be, I respectfully suggest, a somewhat unusual financial world in which it would forego a deduction against New Zealand tax liabilities by issuing an instrument that didn't give it at least the equivalent level of deductions and if it can do so in a way that avoids the consequences that arise from its Danone financing borrowing which is income to Danone Finance in France, then it would, with respect, grab it with both hands.

WILLIAM YOUNG J:

I fear you haven't persuaded me.

MR L MCKAY:

I'm sorry, it's my fault and I'm not deliberately not understanding the questions, but I'm sorry, Sir, if I'm just obtuse today.

GLAZEBROOK J:

I think the question was really without the 55 million from Deutsche Bank and the insertion of Deutsche Bank, this wouldn't have given the tax advantage. Is that more the question?

WILLIAM YOUNG J:

Well, I can't see why it would happen.

GLAZEBROOK J:

But apart from that it wouldn't have given the tax advantage in any event.

MR L MCKAY:

Unless it had a lowest price clause.

GLAZEBROOK J:

I don't understand the lowest price clause I'm afraid. You've totally lost me on that.

MR L MCKAY:

In that context, okay.

GLAZEBROOK J:

I mean we're redoing another transaction I suppose?

MR L MCKAY:

Yes, we are redoing another transaction. I'm only speaking I think –

GLAZEBROOK J:

So that might be a rabbit hole.

MR L MCKAY:

I'm only speaking rationally. If the parties, if the goals of the parties, or the thinking of the parties with reference to this arrangement saw the obvious utility of a lowest price clause from both a New Zealand and a Singaporean

tax standpoint, I'm assuming that might also be carried over to the hypothetical.

The other and remaining and last point I would make about the material attributed, sorry, the material my friend referred to with reference to Professor Choudhry –

WINKELMANN CJ:
Can you just take me back to the very first day Mr McKay and tell me what you say the commercial purpose of this transaction was?

MR L MCKAY:
Yes. The commercial, and my friend referred to some of them this morning, but there were a range of purposes that have popped up, been referred to in documents over time both from the origin of the consideration of the transaction and also descriptions of the reasons it was entered into, or the benefits arising from it following the completion of the transaction.

WINKELMANN CJ:
Yes, but what do you say we should accept as the commercial purpose of the transaction because what the Court of Appeal found was really that the purpose of this transaction was tax advantage?

MR L MCKAY:
Yes, a purpose of this transaction was a tax advantage. If I was singling out, but bearing in mind it's from a tax lens perspective, if I was singling out what the benefits of this transaction were to the group, I can see a number of subsidiary benefits. The increase in the level of New Zealand interest bearing indebtedness to something closer to the thin capitalisation limitation in circumstances where the interest income that is received by the lender within the broader group is non-taxable and both of those consequences occurred, at least unless my learned friend's submission that BG 1 applies is correct because there was a continuation of the deductibility on the debt financing

albeit at that slightly higher level and there was no income tax liability in the jurisdiction of the lenders.

WINKELMANN CJ:
So, you are saying it was improving the tax effectiveness of the funding of the New Zealand company is part of it?

MR L MCKAY:
From a group perspective, that's correct. From the New Zealand standpoint, it didn't.

WINKELMANN CJ:
Because what's interesting is that I had that must be the case that what they were trying to do was stop all this interest being paid within the group because that's not tax effect, one assumes. Although, as Mr Smith said, we don't really know what the tax effect is because there's no evidence.

MR L MCKAY:
No, we do know there is evidence of the financial accounting standards and of course that all disappears on consolidation.

WINKELMANN CJ:
No.

MR L MCKAY:
Yes, we don't know in terms of these actual parties and their purpose or intention.

WINKELMANN CJ:
Yes, but the documents don't speak to that at all, do they? They don't say well we're stopping having to pay interest on all this money, paying tax on all this interest we're paying to the treasury arm. We won't have to pay, the treasury arm won't have to pay interest on this, sorry, tax on this anymore. They don't say that. They've just focused completely on New Zealand.

MR L MCKAY:

But it is nevertheless without a document in France or from Danone Finance to say it, we do know that the difference between, as a matter of evidence because Mr Marcello had access to all the tax records and relevant tax records, said so that rather than tax payable in France on the interest income, the recipient of the economic benefit or gain from the forward purchase agreement paid no tax on that in Singapore.

WILLIAM YOUNG J:

But Danone Finance was presumably paying tax on interest on $144 million.

MR L MCKAY:

Yes.

WILLIAM YOUNG J:

As of the day one of the transaction there's 89 million and 55 million which equate to 144 million, so the group as a whole, if you accept for a moment that the 55 million is in substance a loan, is paying interest on the same amount as it was before.

MR L MCKAY:

I don't understand that with absolute respect, your Honour, because of course it's those liabilities to Danone and to BNP Paribas are interest payables by other members of the group.

WILLIAM YOUNG J:

Yes, I understand that. I do understand the treating of $55 million is a loan, an assumption which you probably don't agree with.

MR L MCKAY:

It's certainly part of it. I don't disagree it's part of the loan, Sir.

WILLIAM YOUNG J:

I think you're going to have to accept it for the purposes of the hypothesis.

MR L MCKAY:

Yes, yes.

WILLIAM YOUNG J:

Okay, so $55 million is accruing interest to Deutsche Bank. $89 million is accruing interest to BNP. There's an exact match between that and the $144 million which has been repaid to Danone Finance. So the same amount of interest is being, broadly the same amount of interest, is being paid.

MR L MCKAY:

I can't take the next step. I don't know quite what that means when one's focusing in terms on Frucor New Zealand as a separate tax paying entity.

O'REGAN J:

Do we know how Danone Finance financed the $144 million advance it made?

MR L MCKAY:

No. No, we don't. We just know generically.

O'REGAN J:

Presumably, if it was paying tax on the interest, it could've deducted the interest it was paying to its bank when it borrowed?

MR L MCKAY:

It would be an unusual OECD jurisdiction that didn't permit that deduction out the other side, Sir. We have no evidence, Sir.

GLAZEBROOK J:

It did refer to it. Some document referred to it being short-term financing but I don't know whether that was just something the particular document writer thought it was. It may have been if this had been spoken about, it may have been a sort of bridging finance if in fact they were looking at doing this transaction from the start.

MR L MCKAY:

I couldn't lay my hands on it immediately, your Honour.

GLAZEBROOK J:

No, I can't remember where it was either.

MR L MCKAY:

But there is a reference to that to BNP, the BNP borrowing which was 87, no, I beg your pardon, 89 million Singaporean equating to about 87 New Zealand. But we're dealing with 19 years ago I'm afraid and the documentary trail is a bit bare, your Honour. We don't know and we had no evidence.

GLAZEBROOK J:

Well, they had to have the money to buy the assets anyway.

MR L MCKAY:

Forward purchase. Yes, they did.

WINKELMANN CJ:

Because one way of viewing this transaction is that they wanted to stop the New Zealand company paying interest within the group because that was not tax effective.

MR L MCKAY:

It's tax effective if you pay it to Singapore in the form this arrangement took. But I agree, if it's interest, yes, there's absolutely no doubt your Honour is correct. If the entire 204 million had been advanced by DAP as an interest bearing loan it would've been within thin cap, they would've made sure that the interest rate on it was a market rate and there would be no more question of the deductibility of all of that interest than there ever was with reference to the interest on the Danone Finance facility.

WINKELMANN CJ:

But they didn't do that.

MR L MCKAY:

But it wouldn't have had the Singaporean tax benefit and that's the last point I am going to make with reference to Professor Choudhry's evidence. Yes, it is absolutely the case as my friend suggested that Professor Choudhry put forward a number of alternative structures not involving the use of a convertible note, all of which, in his view, and his evidence, would have been more conventional, less artificial, less uncommercial than the use of a convertible note here. But it is fair to say, and every one of them has summarised in the appellant's submission because the appellant views that is further confirmation of the really availability of interest deductions under a variety of debt forms. But every one of them would have led to what is called in the papers an income pickup in the recipient, in the lender jurisdiction. It was only the convertible note that led to the receipt of shares in terms of the tax advice in Singapore not on revenue account and the only taxation exposure in Singapore possibly, if they weren't clearly on capital account at the time they were sold.

But going back if I might to the point I was attempting to make unsuccessfully I think before the luncheon adjournment, if we look at the tax position of Frucor New Zealand, then other than the fact that the arrangement gave it a higher level of debt, that higher level being 144 up to 204 to which no exception is taken by the Commissioner of Inland Revenue. Other than that the tax effect of the pre-arrangement position are the same as the tax effect of the arrangement position. It's only the tax position of the lender that benefits the group by having no income tax liability upon it. Your Honour, might I –

GLAZEBROOK J:

Is there a, just to finish that off, is there a comparison of the interest rate on the 144 to Danone Finance as against the one on the convertible note?

MR L MCKAY:

Yes.

GLAZEBROOK J:

And the answer might be you can't just look at it in terms of what the percentages were because of course different market conditions will create different interest rates.

MR L MCKAY:

Yes, there is a comparison. I'm going to take it with you, if I can be indulged for 10 more minutes just to develop briefly the reconstruction and counterfactual.

GLAZEBROOK J:

Right, no, that's fine. Just a question, that was all.

MR L MCKAY:

If I may speak to your Honour?

WINKELMANN CJ:

So we're onto the counterfactual?

MR L MCKAY:

Yes, we are.

WINKELMANN CJ:

This is Mr Smith's last point really.

MR L MCKAY:

Yes. Can I have 10 seconds to reorganise my papers?

WINKELMANN CJ:

Yes, sure thing.

MR L MCKAY:

It's a point and it was discourteous not to even introduce it in a preliminary way during my oral presentation, but I'm afraid time told against us, so I'm at page 27, I'm at paragraph 94 of the written submission and like my learned

friend, I would take you to section GB 1 which is tab 4 of the first of the appellant's bundle of authorities.

Your Honours, I think may recall that when we were looking at the definitions of a tax avoidance arrangement, when we were looking at section BG 1, when we were looking at the very limited statutory task for a tax avoidance analysis I referred in passing to section GB 1 and my friend addressed it in a little more detail in his address to you today. There are three elements of section GB 1 that should in my respectful submission be stressed.

The first of them is if we look at the opening language of section GB 1, where an arrangement is void in accordance with section BG 1. Now, your Honours will recall from section BG 1 that tax avoidance arrangements falling within that provision are void as against the Commissioner and your Honours will know by reference to other cases that have come before this Court and the Court of Appeal that often, in fact usually, the Commissioner stops there. Stops with the voiding effect of section BG 1 and doesn't do anything further than issue assessments indicating that the arrangement is a void one. That was *Alesco* illustratively. The Commissioner took the view that you didn't get any deductions on an interest free loan which is how the courts categorised the arrangement in that case and so it was enough to void the deductions, void the arrangement and therefore devoid the deductions that were taken. So that is very frequently the position. The cases that have come to this Court have largely fallen into that first subset of what happens when BG 1 applies and, to be frank, if you think about those cases and the nature of the fact situations in them, it's not difficult to see why that is so, nor is it with reference to *Glenharrow* in the parallel situation of GST.

I mean, once that *Glenharrow* arrangement has been held to be within their GST equivalent, you don't want to spend much time at an intellectual level in trying to do anything with it. It's effectively a void arrangement other than the minuscule extent to which cash passes.

Okay, in some cases, and moving on in terms of GB 1, where it's void, the amounts of assessable income deductions included in calculating the taxable income of any person affected, and I agree with my friend's submission that that is a general phrase. It certainly extends to Frucor New Zealand in the present case affected by that arrangement, may be adjusted by the Commissioner. Let's just pause there because that's a second subset of the language: "May be". I think in an exchange with his Honour, with one your Honours this morning my learned friend fairly stressed the point, or your Honours stressed the point that that is discretionary. Yes, that is discretionary. It is discretionary on the part of the Commissioner as to whether it, to form a view, as to whether it should be adjusted. But if the Commissioner takes the view that yes, it should be adjusted, or it may be adjusted, what is the standard? It is to be adjusted in the manner the Commissioner thinks appropriate so as to counteract any tax advantage obtained by the person from or under that arrangement. May be adjusted in the manner the Commissioner thinks appropriate so as to counteract any tax advantage obtained by the person from or under the arrangement.

Now, your Honour, just pausing there and applying that to the present case, there is no doubt that the Commissioner has exercised that power in the present case. Okay, she has, I beg your pardon, she being because the Commissioner is a woman. The Commissioner is reconstructing. She's taken a 204 million convertible note arrangement under which $66 million aggregate interest is paid and she is both recharacterising and reconstructing into a net, or leave out the net, a $55 million loan of which 11 million interest is paid over the period of the arrangement. So the Commissioner has adjusted, presumably in the manner she thinks appropriate.

The reservation, or the problem that from a Frucor New Zealand standpoint that that reconstruction has is that it goes so materially beyond the counteraction of any tax advantage obtained by the person, that's Frucor, from or under the arrangement.

Now, what tax advantage, and that involves in my respectful submission, a before and after analysis, what's the position before the arrangement, what's the position under the arrangement. The supposition that's being made in terms of the language of section GB 1 is that there's going to be a better, more advantageous tax position after the arrangement has been entered into than the arrangement beforehand.

What's the arrangement beforehand? Well, we don't need to get into the realm of hypotheticals or counterfactuals for that. We know what the arrangement was. It was 144 million interest bearing debt from Danone Finance on which interest was payable at a market rate. So, the most the Commissioner can do is to say: "Well, that's the position before, what's the position after?"

She, I beg your pardon, she, the Commissioner, is going to have to grapple with the fact that of the better tax position because in answer in general terms to Justice Glazebrook's question, not as high as you would think but there was a higher level of deductions after the arrangement than before. That she's going to have to, she is the Commissioner, I'm sorry, the Commissioner is going to have to bear in mind that as to that proportion of the increase caused by the level of debt rising from 144 million to 204, the Commissioner has no problem with that because that's within thin capitalisation limits.

WINKELMANN CJ:

That's an extraneous consideration, isn't it? How is that a relevant consideration that it's within thin capitalisation rules? The question is what's the tax advantage? I was with you up until the point when you popped thin capitalisation rules in.

MR L MCKAY:

In that case I do still have at my age still some strategic sense. I'm going straight back to the pre-arrangement position in that case, your Honour, and I'm saying let's just assume that she does not have to make any adjustment on account of the fact that the level of increase is with thin capitalisation, let's

look only at the pre-arrangement position and let's look at the level of deductions that arose under that and then let's look at the level of deductions that arose under the arrangement position. The –

WILLIAM YOUNG J:
Can I just ask Mr McKay…

MR L McKAY:
Yes, Sir.

WILLIAM YOUNG J:
I mean, I understand that argument, but isn't the point you're making much simpler, that this was a loan of $55 million dressed up as something it really wasn't? Because it was dressed up as something it really wasn't they got more deductions than they would have for the use of the 55 million, isn't the case as simple as that? And if that is the correct way of looking at it, this argument falls away, doesn't it?

MR L MCKAY:
Yes. Sir, I can't do more to answer the case that you say is against us. Yes, if that is the characterisation that the Court adopts then this argument –

WINKELMANN CJ:
But you would rely on the words of GB 1(1)(a) wouldn't you, which is that the Commissioner "may" take into account what the situation would have been if the arrangement had not been –

MR L MCKAY:
Yes, I would come to that next as a buttress to the points that I think are already there on what this Court in *Ben Nevis* called the "general power", which is the general power that I've been referring to, the power to reconstruct in the manner the Commissioner thinks appropriate so as to counteract a tax advantage, and I'm on even firmer statutory ground, if I might respectfully suggest, when I move to the provision that your Honour referred to, which is

subparagraph (a) of that same provision, which comes even more directly with a focus upon the pre – more explicitly a focus upon the pre-arrangement position, and it involves no more than a comparison of the level of deductions arising post-arrangement to the level of deductions arising pre-arrangement

Might I immediately answer belatedly Justice Glazebrook's question by at least giving documentary reference that shows the level of deductions that arose as a consequence of the arrangement? There's no paper, your Honour, that shows as a comparison on the same page the level of deductions arising pre and post, but that simply becomes, because the pre situation is in the tax returns and the financial statements, to know what the pre position, had it continued with no arrangement, does the job.

GLAZEBROOK J:
Exactly.

MR L McKAY:
And, your Honour, those calculations are contained in – excuse me for a second – those calculations are contained in tab 28 of volume 3B of the case on appeal. The cross-reference – and I'll speak to is very briefly – but the cross-reference, your Honours, is to paragraph 82 of Mr Stanley Marcello's brief. As my friend indicated this morning, Mr Marcello was the sole witness for Frucor, he was simply in charge of the documents, he wasn't there, but he did give evidence with –

GLAZEBROOK J:
Does he put this in words? Because it's very hard to read.

MR L McKAY:
No, he doesn't, in anything like a tabular form – I'm sorry, your Honours. He doesn't in anything like a tabular form like this, but what this document does is – and you'll see it's been prepared for the purposes of a notice of response so it's one of the dispute documents – it's called a simulation of borrowing cost, it takes in the first of the boxed columns towards the middle,

and assumed 149 million borrowing under the Danone Finance facility, and it works out what, having regard to the rate of interest agreed in that cash management facility arrangement, which was the borrowing document between Frucor and Danone Finance, that was a floating rate set by reference to LIBOR or some other reference point. It happens that the floating rate would have quite materially increased during the period of the arrangement, just, floating rates moved so there happened to be a benefit through the fixed rate that was adopted in the convertible note itself. But what he does is saying well if I take the reference rates and I assume that the facility remains at about 149, it moved up and down a bit, but I assume it stayed at 149, I can work out the monthly interest, and these are for the period for the first three years of the arrangements, your Honour, and in the final right-hand column I can show you what the total interest paid would have been under the pre-arrangement situation and it's then, again speaking if I might to Justice Glazebrook, it then just simply becomes a question of working out on the basis of the financial statements and the tax returns what the actual level of interest paid under the arrangement would have been and drawing a comparison between them.

WINKELMANN CJ:

How do you work that out? Has anybody worked that out?

MR L MCKAY:

Yes. Yes. I'm looking at my friend Mr McKay, or not looking at him, in the hope that he can rescue me. Yes, Mr Marcello's evidence does give some aggregates of the level of interest deductions arising to Frucor New Zealand under the arrangement. It's an aggregate, your Honours, it's taken from page 82 – I beg your pardon. Paragraph 82 of Mr Marcello's evidence, and I'm going to ask my friend Mr McKay to give me the reference again if you would, to which tab of volume 1, or volume 2 on the case of appeal is Mr Marcello's evidence? When I find it I'll give it to you.

WINKELMANN CJ:

It's tab 1.

MR L MCKAY:

Tab 1, thank you very much, and it is in paragraph 82 of the written evidence, or record of evidence on tab 1, in paragraph 82 Mr Marcello has calculated the 2006 and 2007 – sorry, that's the case management agreement. By comparison, this is in paragraph 83, by comparison the actual interest expenditure for Frucor under the convertible notes in the same income years was comparable even though calculated on the significantly higher principal amount of 204, and Mr McKay, they don't give us the actual number, and does Mr Marcello not give us the numbers under the convertible note for those two years?

MR M MCKAY:

Well they're similar. It's around 11 million.

MR L MCKAY:

I don't have the mental agility but my friend tells me I simply have to multiply 204 by 6.5. They are, I'm sorry I can't give you the absolute answer –

WILLIAM YOUNG J:

It's 11 million, it's the deductions – sorry, it's what's accepted is the legitimate tax deductions.

MR L MCKAY:

Yes, thank you Sir. The answer seems to be, Justice Glazebrook, we can easily find it out, it's about the same. I'm out of time thank you.

ELLEN FRANCE J:

Mr McKay, just going back to your legal argument on GB 1 on this point. So you say *Alesco* is wrong in relation to that?

MR L MCKAY:

No, I don't have to go that far, your Honour, though I've invited the question.

ELLEN FRANCE J:

Well the Court does reject the argument about having to…

MR L MCKAY:

Yes, that's correct your Honour, but it's in a context, and I passed over the point too quickly 10 minutes ago. It's in a context where the Commissioner relied upon section BG 1 to annihilate the arrangement. In other words the Commissioner didn't have to reconstruct. Now certainly there's no doubt the taxpayer argued you should, and it argued that you should because well everyone, at least in part debt funds in New Zealand business, but it was looking very much, if you like, at a commercial, what it called a commercially realistic counterfactual. It's nothing like a situation here, where is not a hypothetical or a counterfactual analysis other than by reference to an actual existing transaction. Now *Alesco* didn't have that your Honour.

ELLEN FRANCE J:

Well I understood they were making two points. One which is more in terms of what the actual situation was, but the other about the plain terms of GB 1, which didn't seem to me to be consistent with your argument.

MR L MCKAY:

It certainly is the case that Justice Harrison for the Court poured cold water on a suggestion that the Court have an obligation in circumstances like *Alesco* to, on some basis, reconstruct to a likely counterfactual position. Those observations I suppose my point, your Honour, are made in the context where BG 1 annihilated the arrangement and the Commissioner did not have to reconstruct. Here, she doesn't have to reconstruct, but she did.

WINKELMANN CJ:

So the question that might arise as a matter of statutory interpretation in GB 1(1)(a) is what does it mean if that arrangement had not been made or entered into, is the arrangement the entire thing or is it just that part of the financing which was used to dress up what was on the Commissioner's case, a capital injection as a loan?

MR L MCKAY:

There's been no suggestion, including from my learned friend today.

WINKELMANN CJ:

I think he does suggest it actually.

MR L MCKAY:

Well, my friend is suggesting that there was. I do not recall a suggestion being made by the Commissioner that the existing funding arrangement was other than the factual base upon which the actual arrangement to my friend's client takes exception, was, if you like, a necessary precursor.

WINKELMANN CJ:

I think that Mr Smith does say that the Commissioner says you just take out the artificiality. So that means you just take out the wrinkly bit which, on their case, makes what capital looked like a loan.

WILLIAM YOUNG J:

Repayments of interest look like. Capital that look like payments of interest.

WINKELMANN CJ:

Yes. So, that's what they're saying. That's the arrangement that is not entered into, that you take out. So you just take out the tax avoidance aspect of it, so it's not as you say a counterfactual which I should say I suggested to you. It's not as you say a counterfactual where you take out the entire refinancing. It's just a counterfactual where you take out that part which makes repayment of principal look like payment of interest.

MR L MCKAY:

Why that is open is a question of statutory interpretation. I would say that's the first time in any Court that the Commissioner has ever made that suggestion. I'd also secondly say it's absolutely punitive in character.

WINKELMANN CJ:

I think it's quite a straight forward interpretation.

MR L MCKAY:

Because what it does is leave the taxpayer in the situation with everything else that was part of undoubtedly what would have been an integrated arrangement.

WILLIAM YOUNG J:

Just pause there.

WINKELMANN CJ:

Just a matter of statutory interpretation is probably right, isn't it, though?

MR L MCKAY:

Yes.

WILLIAM YOUNG J:

Sorry, just to say if you look at page 18 of your friend's submissions.

MR L MCKAY:

Page 18, Sir, yes.

WILLIAM YOUNG J:

It says: "In circumstances where Frucor avoided tax by claiming deductions for what was in reality repayment of an amount lent, Frucor's tax advantage comprises the deductions claimed."

MR L MCKAY:

Yes.

WILLIAM YOUNG J:

That's the point you said had never been made.

MR L MCKAY:

No, I'm saying that I've never heard the argument made that the Commissioner, when she voids an arrangement, or invokes section BG 1 against an arrangement, is entitled to go through and effectively work out which of the arrangement bits she wants to void and leave the others standing.

WILLIAM YOUNG J:

Can't you just do it to counteract? If you say the substance of the transaction is that a loan is dressed up as something it isn't, let's strip out the smoke and mirrors, look at it as relying on that basis the advantage ostensibly obtained was the ability to claim deductions or repayments of principal. I can't see what's wrong with that under section BG 1.

MR L MCKAY:

Well, it does not, in my respectful submission, doesn't respond to the statutory language. She is certainly reconstructing the arrangement because she is not leaving the arrangement to actually carry on in the form it was implemented by the parties.

WINKELMANN CJ:

I know it is very old-fashioned of me, but I do see this as a question of statutory construction and isn't a question of what the arrangement is. Don't we need to look back to the statute to read the definition of what the arrangement is?

MR L MCKAY:

Yes. I'm not sure it's even in the papers before you but the arrangement includes the plan or understanding whether legally enforceable or not entered into by the parties.

WINKELMANN CJ:

What section is it again, can you tell me the reference?

MR L MCKAY:

It will be, I think, in section OB 1 but I'm not absolutely sure, your, it's in any of the papers that have…

WINKELMANN CJ:

I think it is.

MR L MCKAY:

My friend says it's in the Commissioner's bundle, in which case I'll and find it.

WILLIAM YOUNG J:

The tax avoidance arrangement is the repackaging of a loan as something else then voiding that arrangement leaves you with a loan, repayments of which have been deducted as, have been deducted. So counteracting that arrangement produces the result contended for by the Commissioner.

MR L MCKAY:

Well, that depends. In my respectful submission that is not, either as a matter of statutory interpretation or proportionality or fairness, a proper method of counteracting the very, very limited tax advantage or tax benefit that arose from this arrangement. I mean, on the numbers the case, in my respectful submission, is compelling, and we won't say that the dollars are exactly the same. But if because of the movement in floating rates higher over the period of the arrangement we are left in a position that the deductions that were taken before the arrangement was entered into are materially in ball park terms the same deductions as those that arise under the arrangement they'd entered into, then to adopt the reconstruction of the type that your Honour Justice Young is referring to is not going to answer the statutory direction to reconstruct to remove the tax advantages arising under the arrangement.

WINKELMANN CJ:

Well, the tax advantages arising under the arrangement, the treatment of principal, repayments of principal, as a payment of interest, and when you

look at the definition of tax avoidance arrangement you can certainly fit that within section GB 1(1)(a).

MR L MCKAY:

Yes, you could, but that presupposes, and it's not an analytical framework that is of course, as your Honour is aware, is at all accepted by the appellants, that the 204 million convertible note subscription is anything like a net loan. If it was a net loan of 55 million –

WILLIAM YOUNG J:

Then you're in trouble.

MR L MCKAY:

– then because it's never been resisted by –

WILLIAM YOUNG J:

Sorry. If it's a $55 million net loan then you're in trouble on this argument, aren't you?

MR L MCKAY:

Oh, that's been – that's never been in dispute, Sir.

WILLIAM YOUNG J:

Okay.

WINKELMANN CJ:

Yes, right.

MR L MCKAY:

And I think that my friend quite fairly in his written submissions said it's not been opposed or quarrelled with by the appellant that you don't deduct principal. So to the extent, if at all, that the $55 million is principal, is the repayment of a loan, it clearly isn't deductible, but –

WINKELMANN CJ:

Okay. But then do you go on to say if that's accepted you still then have to pretend the whole thing hadn't happened and look at the…

MR L MCKAY:

Yes, I say that that's the analytical framework that section GB 1 requires, it's required not only by the language of "may be adjusted" by the Commissioner in the manner it thinks appropriate to counteract the tax advantage, because that inevitably makes you look back at what's being replaced, but also when we turn, as your Honour foreshadowed, if we turn to the language of subparagraph (a) of GB 1(1), we see there that even more explicitly the Commissioner may – certainly not quarrelling with the word "may" – but "may" have regard to such amounts of assessable income as in the Commissioner's opinion that would have or might be expected or have or wouldn't or likely he would have had if the arrangement had not been made or entered into, and we know that to a fact, if the arrangement had not been entered into then there is to the highest degree of probability, we have the existing situation involving the $144 million advance from Danone Finance. So it's a counterfactual but it's not hypothetical, because it is the existing situation, it's what to every degree of likelihood must have been expected to have continued if the arrangement had not been entered into.

Your Honours, might I ask for one more minute just simply to leave you with the reference to *Ben Nevis* at the section of this court's judgment in *Ben Nevis* where this question of reconstruction is addressed, and I'll largely leave you with the references without taking you in detail through it. *Ben Nevis* I think is volume, the volume is volume 1 of the bundle of authorities to the appellants, and the reference is at tab 8, and the short discussion of their Honours in the context of reconstruction in *Ben Nevis* is at page 345 of the judgment commencing at paragraph 169 and going through to paragraph 170. Paragraph 169 the Court refers to what it calls the general power under section GB 1, that's the power to reconstruct in terms of tax, to counteract tax advantages, and secondly it refers to what it calls the specific power, which is the power that's referred to in subparagraph (a) of section GB 1(1). It says,

and that's paragraph 170, well in this case the appellants have not discharged the onus upon them, with reference to showing that the Commissioner's reconstruction is wrong, and the paragraph that I want to emphasise is to pick up 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."

Now as my final point I would leave you with your Honours with this proposition, that that onus is discharged both substantively and as a matter of the numbers. It is discharged substantively because we have a transaction, namely the pre-existing arrangement, the Danone Finance facility, to demonstrate both in terms of the general power and what the Court calls the specific power, what the position was most likely to have been if there had been no arrangement, and secondly, the onus is discharged as a matter of arithmetic because by comparison of the table prepared by Mr Marcello, assuming ongoing utilisation of the cash management facility, with the actual level of deductions taken arising under the arrangement itself, we can show to the last final dollar the full measure of the tax advantage required to be counteracted in terms of section GB 1.

So subject to any comments or questions, your Honour, those are the submissions in reply.

O'REGAN J:
Section GB 1(a) I think Mr Smith's submission was that that wasn't engaged here, that the Commissioner was only relying on the introductory wording of GB 1? Does your submission depend on invoking (a)?

MR L MCKAY:
It's materially assisting my respectful submission Sir by (a) but no it's not entirely dependent on it because the counteraction of tax advantages or tax

benefits, as the Court in *Ben Nevis* called the general power that's contained in that provision, that will do. In both cases the Court is saying the onus, the onus point would be common, but the onus is discharged. Or could be discharged if we get this far.

WINKELMANN CJ:
What do you say about – I mean it's not a subsection 1(1)(a), it's actually, it's all part of the same – it's all part of GB 1(1) isn't it.

MR L MCKAY:
Yes.

WINKELMANN CJ:
Wouldn't it mean that it's discretionary because if it's needed to do no more, if it's needed – doesn't it matter, it's not discretionary in some circumstances to take something into account, because if, for instance, just unwinding part of it over-compensates the Commissioner, then the Commissioner would be obliged to take something else into account, for instance the matters in GB 1(1)(a)? There might be circumstances in which the Commissioner is obliged as a matter of law to do the 1(1)(a) step?

MR L MCKAY:
I won't take you to the interpretation statement, but you recall that I referred yesterday to the fact that the Commissioner grappling, and that's no criticism, but grappling with *Ben Nevis* and *Glenharrow* and *Penny* and *Hooper* who had issued an extensive interpretation statement, it's part of the bundle, setting out her understanding for the guidance of her officers and for taxpayers generally as to what those decisions mean, how we grapple with them, how we interpret them, how we apply them. In the course of her exercise, I beg your pardon, her discussion on reconstruction, she makes exactly your Honour's point that sometimes, she's contemplating primarily if it's void, but also if, in the course of reconstructing the taxpayer is denied outcomes that are not themselves offensive in BG 1. Proper tax outcomes is one of the phrases she uses.

It's a similar philosophy to that adopted and the case is referred to in the written submission but Justice McGechan in an old *BNZ Investments* case saying that the province of this provision is to remove benefits arising from avoidance but no more than that and it's the same philosophy. In *Ben Nevis* it's quite clear that the Court is contemplating that there are, if you like, proper bases for the exercise of these powers. In other words, they see it as a reviewable power at both the general and the specific level and some of the considerations that your Honour has referred to like if annihilation or if one aspect of counteraction involves removing tax outcomes that are not offensive, that are not BG 1 themselves, then the Commissioner might have to do that juggling act. But it's all in the subordinate to the role, or means to the goal of putting the taxpayer in a position that has removed the tax advantages arising from avoidance and, in terms of (a), if it's applied parallels or reflects the position most likely to be expected to have obtained if there had been no arrangement.

WINKELMANN CJ:
Thank you. Thank you, Mr McKay.

MR L MCKAY:
Thank you, your Honours. I will just take 10 seconds of housekeeping just to remove all this.

WINKELMANN CJ:
Mr Smith.

MR SMITH QC:
If your Honours please, this is the Commissioner's appeal in respect of shortfall penalties, and I will endeavour to get mostly through it by 4 o'clock. There are three main points in the appeal but before I come to those, just a moment or two on statutory framework. A penalty, a shortfall penalty, may be imposed where there is an unacceptable tax position and the relevant starting point is section 141B of the Tax Administration Act 1994 and you find it in the

Commissioner's bundle of authorities on shortfall penalties which is the only bundle that you will need for this part of the appeal. It's under tab 1.1 and you'll see it's several pages in, 141B unacceptable tax position: So, a taxpayer takes an unacceptable tax position, if viewed objectively, the tax position fails to meet the standard of being about as likely as not to be correct." Then the next relevant provisions, just while we're in that part –

GLAZEBROOK J:
It doesn't come up on our index very well, so…

WINKELMANN CJ:
I can't actually find it.

O'REGAN J:
There is a bundle, I'm sure it will be on it.

GLAZEBROOK J:
I've got the bundle, the actual provisions don't come up in the index very well.

WINKELMANN CJ:
I have got it actually.

ELLEN FRANCE J:
It's under tab 1.1.

GLAZEBROOK J:
So which one is it? Number 1.11.2, 1.1?

MR SMITH QC:
1.1, and it's three pages in.

WINKELMANN CJ:
I thought I'd seen this.

GLAZEBROOK J:
And what are you looking at?

MR SMITH QC:
I'm looking at 141B. So it's 141B, it sets out what is an unacceptable tax position: The taxpayer takes an unacceptable," – I hope that you do have that, your Honour?

GLAZEBROOK J:
Yes, I've got it now.

MR SMITH QC:
"Unacceptable tax position. The taxpayer takes an unacceptable tax position if, view objectively, the tax position fails to meet the standard of being about as likely as not to be correct."

So the next relevant provision of importance is within 141B which – and I'll come back to what this test is about presently. Just going through the legislation, 141B(4), amount of the penalty: "Where subsection (2) applies the shortfall penalty is 20% of the resulting shortfall. Then 141B(7). This is the part of the statute which deals with matters affecting the determination of whether there is an unacceptable tax position, so you have to take into account the actual – under 141B(7)(a): "The actual or potential application of the tax position of all the tax laws that are relevant, including specific or general anti-avoidance provisions," so BG 1s in there, and then also decisions of the court or a taxation review authority on the interpretation of the tax laws that are relevant unless the decision was issued up to one month before the taxpayer takes the taxpayer's tax position, so is a let-off for not being quite current, but interesting and very prescriptive as to what the cut-off point is.

Then 141D is an abusive tax position, 141D(1): "The purpose of this section is to penalise those taxpayers who, having taken an unacceptable tax position, have entered into or acted in respect of arrangements or interpreted or applied tax laws with a dominant purpose of taking or of supporting the taking

of a tax position that reduces or removes tax liabilities or gives tax benefits." So there is a superadded purpose requirement which is a dominant purpose, and in that event the amount of the penalty as prescribed by 141D(3) is 100% of the resulting tax shortfall. As I understand it, there is a let-off of 50% for first-timers in respect of each of those thresholds, 20% and 100%, and so the fact of being a first-timer, so to speak, is of value to a taxpayer.

WILLIAM YOUNG J:
Are you saying a 50% penalty?

MR SMITH QC:
That makes it 50%. The rationale for these provisions is commonly understood to be – and I don't understand it to be a matter of dispute – that of the encouragement of self-compliance with New Zealand's tax laws, we don't audit everybody, and therefore it is in the interests of compliance with the legislation on a voluntary basis to have, in the event that there is non-compliance which amounts to tax avoidance at the various levels we're talking about in the penalties regime are penalties, they're just simply to act as a guard against the development of approach, which is to say well I was, you've got me this time but catch me if you can next time, sort of thing. We don't audit everybody, and that is the rationale.

That is part of the reason why, in my submission, there is relatively little discretion about the imposition of penalties. Once there is a tax arrangements, once it has been held to be tax avoidance because of the effect of BG 1, for instance, and once it has been satisfied that there is an unacceptable tax position which I will come to in more detail how that is to be worked out, because the taxpayer at the time when it took its tax position ought to have known better, then there is no discretion which anybody has. It's purely a question of whether or not that threshold is reached and the same applies if there is an unacceptable tax position which is also found on the facts according to the statutory test obviously to have a dominant purpose of taking advantage of a tax deduction or tax altering effect.

That is, in my submission, a rough and I hope for the time being adequate outline of the statutes provisions and from that in the context of this appeal there arise, in my submissions three main points. The first main point is what is the state of the law as at 1998 as that has been decided by *Ben Nevis* and the reason why I say: "As at 1998," despite the fact that tax positions were taken here in 2006 and 2007 is simply because *Ben Nevis* takes you as far, or takes us up-to-date as at 1998, so we don't need for anything before 1998 or as at 1998. We don't need to look outside of *Ben Nevis* unless the Court were minded to revisit it. So, we only need to look at developments in the law in relation to the application of BG 1 for avoidance purposes post-1998.

So that becomes the second main issue, what if anything has transpired to change the position, if anything, between 1998 and the dates when this taxpayer took its tax positions, and I'm sorry, I had neglected to say that the determination of that date is the date on which they file their tax returns and those dates are 2006 and 2007. That is to say July 2006 and December 2007 and the exhibits, I do have the page numbers, but the tabs are 19 and 20. They simply are the tax returns in case anybody wants to know where they are.

So the first point is the state of the law as at 1998 as per *Ben Nevis*. Although the appellants in *Ben Nevis* relied on *Europa 2* from 1976, this Court thought that *Europa 2*, even taken on its own terms, was doubtful ground for a broad proposition sought to be drawn from it that deductions were beyond attack and that's set out near the beginning of the discussion at paragraph 190 of *Ben Nevis* which you find under tab 8 of the first volume.

And if we just go to, perhaps it is useful to go to *Ben Nevis* for that purpose and, as I say, it's around 190 where the Court said: "It was however by no means clear from its judgment that this is in Europa, the observations of the Privy Council were intended to state such a broad proposition that could be applicable in all situations. Prior to the Privy Council's judgment the New Zealand courts had held an *Elmiger v Commissioner of Inland Revenue* [1967] NZLR 161 (CA) and *Wisheart, Macnab And Kidd v Commissioner of*

Inland Revenue [1972] NZLR 319 (CA) that the Commissioner could apply section 108 to avoid arrangements involving contrived deductions in artificial situations which had the principal end of reducing tax otherwise payable." And then towards the bottom of that paragraph it goes on to say: "In *Mangin v Commissioner of Inland Revenue* [1971] NZLR 591 (PC) the Privy Council appeared by its general approach to have approved the opinions expressed in the Court of Appeal's judgment in *Elmiger*.

Then in the next paragraph 191: "In adopting *Cecil Bros Pty Ltd v Federal Commissioner of Taxation* (1964) 111 CLR 430 the approach in *Europa 2*, the Privy Council made no reference to its earlier approval of *Elmiger* in *Mangin*, nor did it refer to the Court of Appeal judgment in *Wisheart* refusing to apply *Cecil Bros* in a case involving a highly artificial arrangement. The Privy Council's conclusion of incompatibility rested on the factual finding that the taxpayer had actually paid the price claimed as a deduction," which we say is a point of factual distinction here.

So, all of this was, as I say, referred to and not doubted in *Ben Nevis*. In *Ben Nevis* this Court took the view up to and without even considering challenge that to contend that a deductions case couldn't give rise to a BG 1 or equivalent analysis was a doubtful proposition if you were giving advice and looking at the arrangement that your client was about to enter into to see whether or not it could comprise tax avoidance. However, the position didn't improve so far as *Challenge w*as concerned and there we have it in paragraph 193. This Court saying in *Challenge Corporation* Justice Richardson addressed the argument concerning the limited scope of general anti-avoidance provision in the course of his discussion of section 99.

The second paragraph of that quote: "On the other hand, section 99," he said, "would be a dead letter if it were subordinate to all the specific provisions of the legislation. It too is specific in the sense of it being specifically directed against tax avoidance and it is inherent in this section but for its provisions. The impugned arrangements would meet all the specific requirements of the income tax legislation."

Then 194 in the second paragraph above Justice Richardson rejected the argument: “The application of the general anti-avoidance provision was incompatible with the specific provisions.” What he said was approved by the Privy Council in *Challenge.* So to the extent that the taxpayer in that case was relying on the position pre-*Challenge* and *Europa*, this Court didn’t think that it was as clearly in favour of a taxpayer as it was minded to say that even if that had been the case, it certainly didn’t remain the position after *Challenge* and this Court at paragraphs 195 and 196 go on to deal with New Zealand decisions in *Hadlee v Commissioner of Inland Revenue* [1991] 3 NZLR 517 (CA) and also *Miller v Commissioner of Inland Revenue* (1997) 18 NZTC 13,001 (HC) which were decided by Justice Baragwanath in the High Court where Justice Baragwanath said, and this is the quotation set out in 196: “It is a section that deals with transactions altogether lawful in terms of the general law and the general provisions of the Income Tax Act.” I think he means specific provisions. There is no doubt about what he means, “but which nevertheless infringe its terms. Section 99 does concern reality and lawfulness but in a sense quite different from the general provisions. It begins to bite when their operation is complete.”

So that sets out the position up until 1998. Perhaps I should add the paragraph at 198: “Nor would it assist the appellants if the Court were to consider the later decision in *Peterson.*

GLAZEBROOK J:

I’m just a bit puzzled as to why we’re going through that because I didn’t think that was the argument in this case at all on shortfall penalties. Perhaps you just explain what your argument is in one –

MR SMITH QC:

Well the argument is that the Court of Appeal’s approach was wrong.

GLAZEBROOK J:

I understand that, but I don't know that it helps to go through what *Ben Nevis* said, does it? What do you say the test is for shortfall penalties where the Court of Appeal or more likely the High Court have got it wrong?

MR SMITH QC:

The High Court and with respect, the Court of Appeal got it wrong because, at least in the case of the Court of Appeal –

GLAZEBROOK J:

You will have to just make sure when you're saying something important that you do say it into the microphone, sorry.

MR SMITH QC:

The High Court, but more particularly the Court of Appeal got it wrong because instead of carrying out the analysis which I am half way through, it went straight to an earlier decision of Justice Kós in *Commissioner of Inland Revenue v John Curtis Developments Ltd* [2014] NZHC 3034, (2014) 26 NZTC 21,113, and that decision did not involve any form of analysis as to what was the state of the law at the time when the tax position or the tax positions was taken. I'll take you first of all to *Curtis…*

WINKELMANN CJ:

I think your critical point though is, Mr Smith, that on the authorities as they stood in 2007, 2006 and 2007, the appellants Frucor could have been in no doubt that the anti-avoidance provisions were not displaced by a simple black-letter approach to what was –

GLAZEBROOK J:

That's not what was even argued or is argued now.

MR SMITH QC:

Well, no, it certainly is argued now in our submissions.

WINKELMANN CJ:

It is argued now.

MR SMITH QC:

We are saying –

GLAZEBROOK J:

Well, you might argue it in your submissions but I don't understand that to be either the basis upon which the Court of Appeal or High Court took the view or the basis upon which it's been put by the…

MR SMITH QC:

No.

GLAZEBROOK J:

By the respondent on this part.

WINKELMANN CJ:

I think it is argued now by the – I think that is the essence, Mr Smith's point is that's the essence of the respondent's claim.

GLAZEBROOK J:

Oh, okay, is that what the argument is? It's not how I understood the argument to be or what they…

MR SMITH QC:

I'm very sorry.

GLAZEBROOK J:

As I understood what the Court of Appeal was saying, is that on these particular facts it wasn't obvious that it was tax avoidance in the sense that it needs to be to be an unacceptable tax position.

MR SMITH QC:

Okay. I'll come back to this – I see where you're heading…

GLAZEBROOK J:
I mean, that's all it says, because there will be, if it's sort of – well, it could be tax avoidance or it mightn't be tax avoidance.

MR SMITH QC:
No.

WINKELMANN CJ:
I mean, there is something –

GLAZEBROOK J:
Then it's not an unacceptable tax position is what the Court's saying.

WINKELMANN CJ:
Yes. I was following Mr Smith's argument though, I was seeing the point of it. Maybe we just let him finish that point and then we can come back, yes.

GLAZEBROOK J:
Sure, sure. It's just I did want to know where we were going because it just seemed not to be answering the actual, either the decisions as they were made or the submissions that have been made on the other side.

MR SMITH QC:
Okay. I want to try and put you at rest on that subject before continuing, it will only take me a moment, I think, which is that – I'll come back to this analysis, because I've only got a little bit to finish off presently.

But leaping forward to what actually happened, and we can possibly put aside the High Court and just simply look at what happened in the Court of Appeal. In the Court of Appeal the Court relied on an earlier decision of Justice Kós in the High Court in the *Commissioner of Inland Revenue v John Curtis Developments Limited*, and that was an appeal from the Taxation Review Authority, and you find that decision in the bundle of documents – not, sorry, the bundle of authorities – and this is under tab 8, it's the last decision.

GLAZEBROOK J:

Is that your shortfall penalty one?

MR SMITH QC:

It relates to shortfall penalties and…

ELLEN FRANCE J:

It is.

GLAZEBROOK J:

I'm sorry, I just…

O'REGAN J:

It's in the shortfall penalties bundle.

MR SMITH QC:

Yes, sorry, it's in the shortfall penalties bundle.

GLAZEBROOK J:

Yes.

MR SMITH QC:

Everything that I'm going to be referring to is in the shortfall penalties bundle.

WINKELMANN CJ:

I don't actually have it.

MR SMITH QC:

So under tab 8…

GLAZEBROOK J:

I can't open it.

WINKELMANN CJ:

No, mine won't open either.

GLAZEBROOK J:

Sorry, there's something wrong with it.

WINKELMANN CJ:

All right, just tell us the paragraph reference.

MR SMITH QC:

The paragraph is 106, 107, and it's a heading of: "141B Unacceptable tax position". So the issue of shortfall penalties is dealt with by Justice Kós very briefly here in just a couple of paragraphs, setting out the core Tax Administration Act provision, as he has. Then: "[106] the Court of Appeal has noted that there is "some element of fuzziness in the underlying concept". As the provision states, the lens used is objective rather than subjective," no argument with that. "The taxpayer's actual belief is irrelevant," again no argument with that, "But so too is the fact that I have ruled against the taxpayer. That is not determinative of the question. If the taxpayer's argument can objectively be said to be one that, while wrong, could be engaged on rational grounds to be right, shortfall penalties will not be appropriate," and there's no difficulty about that at all. In general terms there have, the way that *Ben Nevis* has looked at it is to say there have to be substantial merits, that's what "about as likely as not to be correct" means, there have to be substantial merits. It's not 50/50, it's, "substantial merits" is the phrase we should stick to, unless of course this Court were minded to depart from that. So then –

GLAZEBROOK J:

So – sorry, are you disagreeing or agreeing with that test?

MR SMITH QC:

So far I have no difficulty with it.

GLAZEBROOK J:

All right, that's fine, that's okay.

MR SMITH QC:

I'm slightly recalibrating it just to get it into *Ben Nevis* terms of substantial merits, if it matters. Perhaps it doesn't.

But the issue that I do have with *John Curtis* with respect to his Honour Justice Kós, appears in this Court of Appeal now, is [107]: "I take the view that the short answer," and it is, with respect, a very short answer indeed, "in this case is that the Authority in a cogent and careful decision, albeit one ultimate I have disagreed with, upheld the taxpayer's argument. It was therefore plainly a stance which a reasonable mind might adopt. In addition, the taxpayer may have gleaned some support for its stance from the Commissioner's own incorrect GST audit." And then the conclusion: "Shortfall penalties will not be imposed."

Now the problem with that is that it delegates the consideration of the reasonableness or otherwise, the arguability, the merits of the tax position taken, to what was decided at an earlier point in exactly the same case, when that is the very matters under review. It could well be that under the, at the first instance the decision-maker had thoroughgoingly got it wrong, it could be, in another case, that this decision-maker had got it completely right, and it could be that the decision-maker had arrived at a point, a mid-point somewhere in between where it was, as likely as not, to be correct, and so you wouldn't impose shortfall penalties. But one does not, in my respectful submission, assess the likelihood or not, as the case may be, of the taxpayer's position being correct with reference only – and I would say not at all – to the very decision which is under review. You go to the –

WILLIAM YOUNG J:

Can I just pause there and ask, if the fundamental issue was one of law, a straight-out question of law, then the fact that a judge in the court below has concluded it was correct is possibly a proxy for the view that it was at least arguable.

MR SMITH QC:
And it shouldn't be.

WILLIAM YOUNG J:
Well, yes. What may be – well, yes, it's only a proxy. But if it is genuinely, it's likely to suggest – perhaps "a staying point" is the wrong term – but it's likely give an indication that the argument was arguable. But if the question is essentially one of fact or appreciation and you succeed on an appeal on the basis that the Judge just got the whole thing wrong –

MR SMITH QC:
Yes.

WILLIAM YOUNG J:
– this was a loan dressed up as something it wasn't, and if you're of the view that the Judge was wrong in treating it as, how it was presented –

MR SMITH QC:
Yes.

WILLIAM YOUNG J:
– then you don't really have a problem with the Judge's conclusion, do you, at this point? It's not a bar to the Court.

MR SMITH QC:
No.

WILLIAM YOUNG J:
Now I suppose there's a bit of a problem because the distinction between points of law and fact may be a bit fuzzy at times…

WINKELMANN CJ:
Well, there's a factual finding implicit, isn't there, as to what the purpose of the arrangement is?

MR SMITH QC:

Once you've got a factual finding, and so –

WINKELMANN CJ:

Well, I was thinking how does that factual finding relate to that test, as likely as not? Because the fact is – it's a funny thing to…

MR SMITH QC:

You would have to form – well, before we talk about what happens in this Court, and because in the end it should matter but I have to say why, in my submission the Court of Appeal might well have thought, as a rough and ready but strictly temporary shortcut: "Well, if in the Court below they thought it was reasonably arguable, so might be," but they had to make, accordingly to the law in *Ben Nevis*, in my submission, their own assessment. It can't be devolved simply to what was decided in the Court below for the very reason that that's the matter under appeal, and that's the difficulty that I have with it, and that it, with respect, what seems to have happened in the Court of Appeal in this case, because the analysis refers to *Curtis* and nothing else, it doesn't refer to anything else about shortfall penalties and how it's worked out. And I'm not going to take you to the passage because I don't think I'm doing the Court of Appeal any injustice simply saying it does rely on *John Curtis* and does say that there was here an experienced and commercial Judge who took the view that it wasn't tax avoidance, ergo it was, as likely as not, or it was, there were substantial merits to say that it's likely or not.

The correct approach, in my submission, is for the Court of Appeal, and it would also be for this Court, to take its own view, which it reaches before the substantive part of the appeal, and make a decision as to just how arguable in retrospect, at the time of taking the tax positions, given the law, given that's, the application of the law is the very matter under discussion, and not, in my submission, to effectively, retrospectively, delegate the exercise to the Court below, because that's what's happened, and shouldn't.

So that is, I rely on the submissions, but that's the point, and there's only so many ways I can say it.

WINKELMANN CJ:
And you say – oh, so were you going back to, you were nearly finished your legal analysis?

MR SMITH QC:
Oh, well, yes, I suppose I had better go back to *Peterson*. There are three cases which were heard, of note should I say, they were all heard after *Ben Nevis*, which I hope I've got the order right. But they are AHB, *Commissioner of Inland Revenue v Auckland Harbour Board* [2001] 3 NZLR 289 (PC), *Miller v Commissioner of Inland Revenue* [2001] 3 NZLR 316 (PC) and *Peterson,* and it perhaps does not much matter what was said in AHB and Miller for the reason that *Peterson* came in 2005 whereas those two were in 2001, and *Peterson* gives a very clear view about what is the correct position with reference to tax avoidance.

So that's at, the *Peterson* decision is in this bundle under tab 7, and tab 7 – sorry it's at paragraph [42], beginning there: "Consistently," this is a case of course in which the taxpayer lost, sorry, the Commissioner lost, and what matters is not who won or lost particularly on the facts of those cases, we're just talking about what is the test for present purposes. Paragraph [42]: "Consistently with the statutory purpose," that's in relation to the tax avoidance provision, "it is not only necessary but also sufficient that the taxpayer should have incurred capital expenditure in acquiring an asset for the purposes of trade. The focus is on the party who acquires the asset. It does not matter what the party who disposes of the asset does with money. It is therefore quite wrong to suggest," et cetera, et cetera. Then down to line 24: "If the Commissioner had shown that the features on which he relied, singly or in combination, had the effect that the investors, while purporting to incur a liability to pay x plus y to acquire the firm, had not suffered the economic burden of such expenditure before tax, which Parliament intended to qualify them for a depreciation allowance, then he could invoke section 99," and then

for good measure the end part of the, the main part of paragraph 43, beginning at line 37: “The fact that the production company made a profit of $y at the expense of the investors did not mean they did not suffer the economic cost of paying it.” The point in referring to that of course is to say that throughout it was perfectly that in tax avoidance cases where it is said to be an effect by means of, it’s not an income tax avoidance case but a deduction tax avoidance case, it was thoroughgoingly clear in *Peterson* in 2005 that you had to incur the cost, you had to incur the economic cost, the benefit, the burden, in respect of deductions which you were claiming, and if you were merely purporting to incur them artificially by a structure then it may all be that BG 1 applies.

So that is as up-to-date as relevantly necessary that the tax advisor for Frucor needed to be at the time when the tax positions were taken, and the correct analysis in my submission would be in this case it is, there was tax avoidance, and there was nothing in the law between 1998 and 2005 which said otherwise, quite the contrary, there was *Peterson.*

GLAZEBROOK J:
So, is the argument if it is taxable, you have to have penalties because it will always be an unacceptable tax position?

MR SMITH QC:
No.

GLAZEBROOK J:
Well, then what is the test because it goes without saying and right from *Challenge* that just because you meet a specific provision doesn’t mean it’s not taxable enough so that’s just absolutely clear and I didn’t understand the argument to be we meet the ordinary that totally accepted it was a two stage test by now the respondents on this cross-appeal, so, what is the test on unacceptable tax positions? So, it’s not taxable, therefore it’s an unacceptable position.

MR SMITH QC:

The test in general terms is in the Act about as likely as not to be correct and that has been interpreted in *Ben Nevis* as meaning that the taxpayer had to have substantial merit in their argument. So, when you come, this is an extension of the tax avoidance case in which we've just spent the last two days arguing, when you come to make a decision in relation to the application or otherwise of BG 1 in this case, you also decide by what margin you reach that result and if you reach the conclusion that notwithstanding what Justice Muir thought or anybody else and more particularly notwithstanding the arguments that have been put forward by my friend Mr McKay that the Commissioner succeeds by some margin to the point where there were not substantial merits to the argument against BG 1, then you would conclude that it was not about as likely as not in terms of the statute.

GLAZEBROOK J:

Well, that's what I had always understood the test to be. I thought you were positing another test.

MR SMITH QC:

No and so the answer is almost intrinsic in the BG 1 exercise.

GLAZEBROOK J:

Yes, I understand that.

WILLIAM YOUNG J:

How do you, just go back to the point I raised with you earlier, the requirement is to approach it objectively. Does that mean by reference to the facts that they truly are?

MR SMITH QC:

It's opposed and obviously in terms of what a person looking at the tax laws on one hand and the arrangement on the other hand.

WILLIAM YOUNG J:

You have to look at the facts because you can't just have a sort of an interpretation of the law that's free floating.

MR SMITH QC:

I would've thought you would've had to simply for the reason that the two processes of deciding whether it's a BG 1 avoidance case or not is an intense factual exercise and a person taking a tax position would have to have, one would think, some appreciation of the facts. I suppose you could imagine a case –

GLAZEBROOK J:

Probably another context you might, because there has been other cases where the Commissioner has done a flip flop on what those – so they've had an interpretation statement saying you can do X and then decided that you can't do X and you have to do Y and then obviously in those cases it's an interpretation of the legislation itself. If you happen to be on the wrong side of it you might still have an acceptable tax position. I'm using a situation where the Commissioner has done a flip flop only to show that you probably are relatively – it would be understandable if you relied on a particular interpretation of the law that had been said to come from an authoritative source.

MR SMITH QC:

Well, if you are to say that, it might have a little bit of difficulty with section 141B either (4) or (7) which is what you look at in order to decide whether or not what is the state of the law and whether or not it's reasonably arguable because you're required to look at the cases. It expresses says in the court and also in the TRA.

GLAZEBROOK J:

Oh no, I'm positing a situation where there's no case at all. That this is the first case that's come.

MR SMITH QC:

Oh, okay, well that might be different.

GLAZEBROOK J:

It was just an example that where it could be just a pure legal interpretation of something.

MR SMITH QC:

Well, there could be a case, I'm sorry, your Honour, I've interrupted a question. I didn't mean to. I'm sorry, your Honour.

WINKELMANN CJ:

No, carry on, answer Justice Glazebrook.

MR SMITH QC:

It could be a case where nothing like the exact structure had been put into place, but nevertheless, the notional tax advisor carrying out an objective exercise would be expected acting reasonably and with professional competence to apply the law even to a novel situation notwithstanding that there wasn't any other case like it, so that wouldn't be a complete answer. If anything is clear from the tax avoidance cases and particularly from the external writing on the cases is that each and every single case is an intensely factual exercise and so that probably translates to, it has to translate actually by definition into the exercise you would carry out for determining whether or not shortfall penalties ought to be imposed.

WINKELMANN CJ:

When we look at tax avoidance, to make a find of tax avoidance you have to make a finding that its purpose was tax avoidance?

MR SMITH QC:

Yes.

WINKELMANN CJ:

So, can it be an acceptable tax position when you've found that its purpose is tax avoidance. Can you help me here?

MR SMITH QC:

It does seem as if intrinsically you can because the test is unacceptable tax position and you take an unacceptable tax position if it was not about as likely to be correct as not. So, in other words, it's a separate exercise, but it's a linked exercise in determining whether or not there are shortfall penalties. I mean there are examples, this being such a case.

WINKELMANN CJ:

Well, yes, but can you assist me with the scheme of the legislation because I think that's where I'm having difficult. Does unacceptable tax position only apply to tax avoidance, or does it apply more widely?

MR SMITH QC:

It must apply more widely. It expressly includes BG 1 though.

GLAZEBROOK J:

That's what I was talking about in terms of different interpretations of particular provisions and especially where there has been an issue in terms of how the Commissioner is interpreting things. I can't think of an example immediately.

WILLIAM YOUNG J:

You can treat a receipt as on capital account when it really should be treated on revenue account. That could be either just an income dispute that's legitimate either way or it could be an unacceptable tax position.

MR SMITH QC:

Subject to what the financial arrangements rules have to say about the difference between the two, but yes. If your Honour's point is that I have correctly apprehended, it's not an abstruse area. It's difficult of course, but

there is any amount of jurisprudence as we've just been going through against which the notional tax advisor would objectively base their advice.

WILLIAM YOUNG J:
The Chief Justice's point is, and I'm not sure whether you really picked it up, if tax avoidance involves a purpose to avoid tax, then a finding of tax avoidance gets you a long way towards a finding of an unacceptable tax position?

MR SMITH QC:
Well, yes it does.

WINKELMANN CJ:
If not the whole way.

WILLIAM YOUNG J:
Maybe the whole way.

WINKELMANN CJ:
That's what I'm asking you to grapple with, Mr Smith, and maybe I'm wrong, on a wrong tangent here because I suppose it might be that you would say: "Well, that's the tax purpose." You might fit into a category of a person where that's the purpose of the scheme but it's not the particular taxpayer's purpose, but they're still hit with it. So they might be able to bring themselves into it was an unacceptable tax position. Well, they're still caught with an unacceptable tax position.

GLAZEBROOK J:
I suppose it's the likelihood that it was the purpose of the scheme. So, I think if you are looking at what Justice Kós was saying, he was saying that he's by a relatively narrow margin disagreed with it as being whatever he said the purpose of the scheme. I'm sorry, I don't have it in front of me and I don't have the case, but by a narrow margin decided it was the purpose of the scheme, therefore it wasn't an unacceptable tax position. On *Ben Nevis* I

would've thought you would say: "Well, it's so far not an acceptable tax position that there's not an issue with that.

MR SMITH QC:
Yes, I would say that.

GLAZEBROOK J:
On a factual basis.

MR SMITH QC:
On a factual basis and I see that I have not picked up the Chief Justice's point but I do now.

WINKELMANN CJ:
Yes, because my point is that it's a finding of fact is what the purpose is and once the fact is found, it's not really arguable, it's a fact. Fact is found existed and you may have persuaded the Court that it didn't exist, or you may have persuaded the Court that if you're the Commissioner that it did exist. But once it's found it existed you had a purpose which was taxable in this.

MR SMITH QC:
You would think that you are most, if not all, of the way there in many if not most cases. I would submit that that would be correct but for the sake of good order, the Tax Administration Act imposes a distinct threshold which is to say that the position taken must not have had substantial merits or be as likely so.

WILLIAM YOUNG J:
Well, I suppose you might have a, yes, you might have a situation where the taxpayer has entered into an arrangement which falls foul of section BG 1 but raises an argument that it is exempted by a particular provision.

MR SMITH QC:
That is the area that the Tax Administration Act is intended to cover in the event the factual situation you've outlined, your Honour, applies is correct.

It may well be that it's really marginal, if non-existent in most cases, but there is a certain amount of reticence so far as the law is concerned in visiting what are penalties just like that. There is a further step which is to be undertaken which on the facts and the law in the circumstances of a particular case may well be answered by the BG 1 analysis because you're going through exactly the same evidence if it's a BG 1 case.

GLAZEBROOK J:

I was going to say it's the balance of probabilities 51% as against 49 as against say *Ben Nevis* where you found that 100% as against 0%, I think that's the issue isn't it that at least that Justice Kos was saying and it's not a 50/50 I understand but if you've got a good argument –

MR SMITH QC:

And you miss by a narrow margin –

GLAZEBROOK J:

And you miss by a narrow margin –

MR SMITH QC:

Then maybe not.

GLAZEBROOK J:

Are you accepting that is the test? As the test not as it's required in this particular case?

MR SMITH QC:

The only thing is that we've had some derogation from what the test is actually expressed to be in the statute and has been expressed to be in *Ben Nevis*. We've had Justice Kós in *John Curtis* and also the Court of Appeal where Justice Kós was presiding which really looked at what the earlier decision-maker made. So I am, please forgive my reluctance to look at any other way of describing the test, it's substantial merits.

GLAZEBROOK J:

I understand.

WINKELMANN CJ:

Perhaps we should take the adjournment now anyway. We're way past the time and you can look at your junior's note over the evening and we can re-engage on this in the morning.

COURT ADJOURNS: 4.12 PM

COURT RESUMES ON THURSDAY 10 JUNE 2021 AT 10.02 AM

MR SMITH QC:

Thank you, your Honours. I had almost finished yesterday. I envisage finishing quite shortly but three additional points to make. The first is another way of putting the difficulty that we have on the question of the assessment of the approach to shortfall penalties in the Court of Appeal which is that the difficulty with the Court of Appeal's approach which is placing significant weight, or not thorough goingly so on the judgment in the Court below is that it runs the risk of impounding into the assessment for liability for shortfall penalties the reasoning which is made in the decision which is appealed from and it could be that, and I'm just talking about the approach at the moment as opposed to specifically to this case, it could be that the approach is palpably wrong.

A number of points about that. First of all, it can go both ways. It could be that there was a decision made in the Court appealed from where it has been held that there is an unacceptable tax position and that there is a dominant purpose of the arrangement which makes it an abusive tax position based on factual findings which is to say that it has reached the position of an abusive tax position by a country mile, by some margin whereas it could be that the facts are that that assessment was awry. In other words, off the scale wrong against the taxpayer's interest, so it can go both ways and if the Court of Appeal, or any appellate court, places undue or indeed very much weight at all, particularly in the context of an appeal where the actual tax position merits as being examined in any event, then it runs the risk, as I say, of impounding the errors inherent in the lower Court decision.

Just one other way of exemplifying that in the circumstances of this case, there were, for example, two, amongst others, two areas where the Commissioner and the Court of Appeal said that the High Court had erred, amongst others. One was, for example, the group approach and the other one was economic equivalence. Let's take, for example, the group approach

and assume for the purposes of this hearing, because it's being argued and we know what, eventually will know what the rights and wrongs of that are, but let's assume for the purposes of this argument that it is a thorough goingly wrong approach to say that the Commissioner adopted a group approach. If the Court of Appeal is right, then in its assessment of the substantial merits of the case drawn largely from the first instance decision, that mistake, and it is a mistake because we're assuming that for present purposes, has been impounded into the appeal Court, the Court of Appeal's assessment.

The next submission I wanted to make just very briefly is just to remind your Honours that again the test for an abusive tax position is that there is a dominant purpose but particularly to say that the dominant purpose is that of the arrangement not the purpose of the taxpayer. It's again, not subjective.

And then for the rest of it I am, given that we have argued de novo the substance of the position during the course of the first appeal, I am content to rely on the submissions that we make.

GLAZEBROOK J:
Just in terms of the abusive tax position, given that it can be somebody affected by the position and I'm just thinking of some of those situations where people weren't given the full information as to, I'm going to say, some of those film investments or bloodstock investments, are you suggesting that those people who filed the tax returns in accordance with advice that was actually wrong would be an abusive tax position because you're looking at the arrangement?

MR SMITH QC:
Yes. Not a point that bites in this case, but the answer is yes.

GLAZEBROOK J:
No, no, I understand. It seemed a surprising proposition given that you often do have people affected by the arrangement who of course should have their tax position reversed, but it seems fairly harsh to say in circumstances, and

I'm positing those circumstances where the investors were actually not told the full story by any means.

MR SMITH QC:

At one level of the argument, with respect, I agree, but that seems to be the effect of *Ben Nevis* which is at 204 and through to 207 and I think that my friend and I Mr Mathew McKay are on common ground reading our submissions on this that there is a clear finding that it is the purpose of the arrangement not the purpose of the taxpayer. That point was argued by Mr Harley in *Ben Nevis* expressly as you'll see from the later paragraphs in *Ben Nevis* that it was the purpose of the individual investors which was to be assessed as being the relevant purpose remarking as he did that they themselves might not have been perfectly informed and yet the Court's decision was it was the purpose of the arrangement. That is consistent with the statutory language, but it is also consistent in terms of harshness is that penalties, where applicable, in revenue gathering statutes do tend to be heavy. So, in some ways it's not surprising in my submission, but as I say and as I think we're on common ground, it's not an issue that bites in this case.

Unless I can be of further assistance, those are my submissions on shortfall penalties.

ELLEN FRANCE J:

Could I just sorry, just two things. Frucor identifies the *Auckland Harbour Board* Privy Council decision as relevant in terms of their timeline. What's your response in relation to that?

MR SMITH QC:

Auckland Harbour Board does not say very much which is of assistance to Frucor for two reasons. First of all, its high point is Lord Hoffman saying that the general anti-avoidance rule is a longstop. It's not a particularly carefully examined consideration of the law in relation to anti-avoidance at that time. But secondly, it's followed by *Peterson* and albeit that the Commissioner lost

in that case, that's only be dint of a concession that was made by the Commissioner in *Peterson* and so the outcome was nothing to the point in *Peterson*. What is to the point is the dicta that I took you to yesterday and that clearly shows that there was, in my submission, on a review of the substantial merits as at 2006 and 2007, after Peterson, in my submission there was a substantial risk of this being avoided.

WILLIAM YOUNG J:
What's the last tax return, what's the date of that?

MR SMITH QC:
2007. there's 2006 and 2007.

WILLIAM YOUNG J:
Yes, but in the series though, because there are more to come, aren't there?

MR SMITH QC:
What, in the series.

WILLIAM YOUNG J:
I thought part of the case had been –

MR SMITH QC:
It must be for the 2008 year. '07. '07 is the last one under review because I think that the taxpayer took a protective position after that and filed defensively. So it's…

ELLEN FRANCE J:
Sorry Mr Smith, my only other question was, do you agree that in this context you can look at determinations such as the accrual ones that Frucor refer to?

MR SMITH QC:
The position would be, in my submission, governed by the provisions of the Tax Administration Act that I took you to yesterday, namely 141B(7)(a) and (b), so it's the: "Decisions of a court or a Taxation Review Authority on the

interpretation of tax laws that are relevant." That, by and large, should be it. That's the –

GLAZEBROOK J:
Well it is subordinate legislation isn't it? The determinations?

MR SMITH QC:
It is subordinate legislations. However, section 141B(7), not (a) but (b), it says: "The actual or potential application to the tax position," and (b): "Decisions of a court or Taxation Review Authority..." What I would say though is that the reasoning contained in any other document which might be of relevance would go to an appraisal of the substantive merits on an argument concerning shortfall penalties, and may well carry the day.

ELLEN FRANCE J:
So you're reading 141B(7) as limiting in that sense?

MR SMITH QC:
Well I have to accept that all it says is that the matters that must be considered are the decisions of the court or the Tribunal, et cetera, et cetera, so it doesn't expressly limit it, and that's why I say that anything else that one may find would go to a consideration of the substantial merits on a rational appraisal. I mean, for example, if you had a decision of a court, I won't say which one, and you might as a taxation advisor on a rational basis disagree with it, but nevertheless it represents the law, I'm talking purely in theory here, and has for some time, and there's no indication that it will necessarily change, in that case you would be able to take that into account with, to adopt a shortcut in the argument relative impunity. But on the other hand were you to take into account subordinate legislation, or even a reasonably authoritative article from a university professor which espoused a well-argued but nevertheless contentious point of view, then you may not fare so well in your argument, much less a Twitter feed.

WINKELMANN CJ:

So notwithstanding section 141B(7) you accept that determinations could be relevant as could articles.

MR SMITH QC:

Well they would inform an appraisal of the substantive merits. Sorry, the substantial merits as those words they used in *Ben Nevis*.

WINKELMANN CJ:

Because 141B(7) says "must be considered".

MR SMITH QC:

Yes.

WINKELMANN CJ:

Yes.

MR SMITH QC:

Unless there's something else that I can help your Honours with, those are my submissions.

WINKELMANN CJ:

Thank you Mr Smith.

MR M MCKAY:

Thank you your Honours. Perhaps if I could just address that last point just very briefly. Determinations are issued pursuant to the Tax Administration Act. They have the effect of being binding on taxpayers and it's Frucor's submissions that for all intents and purposes they are part of the law that must be considered, both the unacceptable tax position and abusive tax position standards, and in one sense they're very specific legislation in that they apply to exactly the type of instrument that's issued by the taxpayer in this case.

WILLIAM YOUNG J:

What are the determinations are you relying on?

MR M MCKAY:

The determinations we rely on are determination G5C.

WILLIAM YOUNG J:

Is this in your submissions?

MR M MCKAY:

Yes, it will be in the submissions, I can come to it.

WILLIAM YOUNG J:

And does that deal with convertible notes?

MR M MCKAY:

Yes, that's correct. So G5C deals with mandatory convertible notes, which this is, and we agree – sorry, commercial effect rather than legal effect. It is, at law –

WILLIAM YOUNG J:

What's the relevance though because they can't exclude, specific provisions don't exclude the general avoidance rule.

MR M MCKAY:

No they don't, but what they do, do in a very specific manner is set out what elements of a convertible note are interest giving rise to deductions –

WILLIAM YOUNG J:

But if the whole thing is an avoidance scheme we just go to section BG 1 don't we?

MR M MCKAY:

Well I'd say that in terms of determining what Parliament's contemplation is, with respect to these types of instruments, that the determinations give us a

very specific guide your Honour. The other thing that they do that I think is significant here is confirm that debt is paid in full when shares are issued in discharge of debt.

WILLIAM YOUNG J:
But isn't this just a variant of the argument that was rejected in *Challenge,* that compliance with specific avoidance rules excludes reference to the general avoidance rule?

MR M MCKAY:
No, your Honour, in the sense that I think when we've got to where we've got to in *Ben Nevis*, we need to look at what Parliament's contemplation is with respect to those specific provisions, and they provide it in quite specific directions with respect to convertible notes.

WILLIAM YOUNG J:
Well you'll take us to them.

MR M MCKAY:
I will. Now your Honours I'll just start by briefly catching you up in the written submissions to where I propose to start my oral presentation. I'm at paragraph 1 of the submissions if you have them in front of you. Paragraphs 1 to 3 are purely introductory and describe the assessments that Frucor is facing and the outcome of the High Court and Court of Appeal decisions. Paragraphs 4 to 5 I summarise Frucor's arguments with respect to shortfall penalties, and I will be addressing each of them in turn. Paragraphs 6 to 10 of the submission describe facts that are relevant to the issue of shortfall penalties that have not been raised directly, at least in the context of the substantive BG 1 submission. Then describe at paragraphs 11 to 17 the statutory provisions of the Tax Administration Act that set the standard for the unacceptable tax position in section 141B and the abusive tax position at section 141D of that Act, and I won't take you to them, my friend Mr Smith did that yesterday, but what I will say about them is that the about as likely as not

to be correct standard is a prerequisite to the application of both penalties, and it will be the focus of Frucor's submission.

WILLIAM YOUNG J:

How does that apply to I suppose what are valuative issues of fact. So if the valuative, if the overall factual assessment of an appellate court is that this is smoke and mirrors, and this was only ever a $55 million loan, does the fact that on the appellate court's view the first instance judge has simply got the facts wrong. Does that leave any scope for weight to be placed on the first judge's view?

MR M MCKAY:

It does your Honour, because penalties assumes that the substantive issue is being resolved against the taxpayer. You are then asking, when you come to the "about as likely as not to be correct" standard, by how far wrong the taxpayer got it, and I don't see –

WILLIAM YOUNG J:

Well take a silly example. Say the taxpayer's position turns entirely on a document which is shown later to have been forged. The taxpayer wins in the High Court, the forgery is later exposed. It can't be, well, my prospects of getting away with this forgery were about evens therefore it's not an abusive tax position. Now that's an extreme position.

MR M MCKAY:

Yes, I imagine the taxpayer would face other consequences more severe than penalties.

WILLIAM YOUNG J:

Yes, so in this situation it's not quite like this because what in a sense is a factual assessment, what's the economic substance of this transaction, is influenced by legal considerations, for instance, is that a legitimate question to ask.

MR M MCKAY:

Yes your Honour, and I know the direction in *Ben Nevis* is that this is an intensely based factual inquiry, but if we could focus on the second stage of the *Ben Nevis* test, just for a minute, and that's determining whether the tax positions taken are within Parliament's intent and contemplation, then you can see, in my respectful submission your Honour, that there could be a divergence of views as to what Parliament's contemplation is with respect to specific provisions, and whether the taxpayer's positions are within them or not.

WILLIAM YOUNG J:

That depends a bit on how you analyse the factual basis of the tax position, because I mean if you do treat it, and I'm using slightly loaded language, treat it as next door to a sham, then a High Court judge who goes with it isn't going to control a later court who says it's that, and the more I suppose factual assessment that – sorry. In terms of whether this was Parliamentary contemplation you have to understand what it is. So doesn't that test have to be applied by reference to the factual assessment of what the scheme actually is?

MR M MCKAY:

Yes, only in part, and I think your example down that end it probably works okay. I think in that scenario that obviously the legal arrangement was purported to have effect and the document wouldn't have that effect vis à vis the Commissioner or other parties, but I think we are in that extreme case absolutely and just to be clear, and we will get there, but it's not Frucor's submission that an appellate court is in some sense bound on the issue of shortfall penalties merely because of a lower court decision, and we'll get to both the *John Curtis* decision and the Court of Appeal's decision here where I say, with respect to the Court of Appeal's decision, there is an independent finding on substantial merits, and with respect to *John Curtis* and both decisions a view taken about the quality, cogency and detailed consideration given in both lower court decisions before making a finding independently on shortfall penalties. But to the extent it's the Commissioner's concern that the

taxpayer's argument is that a mere finding in a lower court is sufficient on the issue of shortfall penalties, that is not Frucor's submission your Honour.

I am at paragraph 19 of the submission under the heading "The 'about as likely as not to be correct' standard." And making okay progress at page 5, but I will slow down a bit there. I would like to recap on the various expressions of the standard in the various commentaries and reports leading to the enactment of the penalties regime in 1996, and the various articulations of that standard as expressed judicially since its enactment. I'm at paragraph 20 of the submission, and this is the *Ben Nevis* standard which my friend has already taken you too, but just stated again: "…this standard does not require the appellants' tax position had a 50 per cent prospect of success, but subject to that qualification, the merits of the argument supporting the taxpayer's interpretation must be substantial."

I'm then at paragraph 22 citing there from the finance and expenditure committee report on the second reading of the Bill, enacting the penalties regime, that would eventually enact the penalties regime, and this is a report from the committee on advice from officials about their interpretation and intention with respect to the standard, and this is all in the context of the committee ultimately getting comfortable with that expression of the standard, and they say there: "Officials advised us that 'about as likely as not to be correct' means that a position does not have to be the correct position, or even have a 50 per cent chance of success, but must be a position which would be seriously considered by a court."

Then your Honours, I'll go quickly, but at paragraph 23 this court in *Ben Nevis* cited the *Walstern Pty Ltd v Federal Commissioner of Taxation* [2003] FCA 1428, (2003) 138 FCR 1 decision as making a helpful observation about a similarly expressed standard in the Australian penalties regime, and said that: "The word 'about' indicates the need for balancing the two arguments, with the consequence that there must be room for it to be argued which of the two positions is correct so that on balance the taxpayer's argument can objectively

be said to be one that while wrong could be argued on rational grounds to be right."

Then later in that decision of the Federal Court of Australia: "The case must…be one where reasonable minds could differ as to which view, that of the taxpayer or that ultimately adopted by the Commissioner was correct. There must, in other words, be room for a real and rational difference of opinion between the two views…".

And I summarised at paragraph 26 of the submission of those various expressions with footnote references to where they derived from in case that's of convenience to the Court.

I will go back to paragraph 25 of the submission where the *John Curtis* decision is addressed, and say there that a view is taken in his Honour Justice Kós, as he then was, about the quality of the lower court decision of the Taxation Review Authority in that decision, rather than merely deferring to it without any assessment, and in the first paragraph there there's an expression of the standard based on the *Walstern* articulation of the test in *Ben Nevis*, and in the second paragraph there: "I take the view that the short answer in this case is that the [Taxation Review Authority], in a cogent and careful decision – albeit one ultimately I have disagreed with – upheld the taxpayer's argument. It was therefore plainly a stance which a reasonable mind might adopt."

I say there, your Honours, that this finding does not involve complete deference or deferral to the Taxation Review Authority decision. That a view is taken about the quality of that lower court judgment.

WINKELMANN CJ:

It might be rather stunting of the development of the law though, mightn't it, if, it would compel us, say there was a dissent within our court, it would compel

before the shortfall penalties could be imposed we would have to form the view that dissent was unreasonable. It just doesn't sound like a…

MR M MCKAY:

Yes, I wondered the same thing last evening your Honour. Yes, I imagine that would be quite difficult for your Honours.

WILLIAM YOUNG J:

They could simply say it's a different view of the facts.

MR M MCKAY:

Again your Honour I think that would only get you half way there in terms of the *Ben Nevis* directions as to how we approach the tax avoidance analysis.

WILLIAM YOUNG J:

But if you view – I mean as I said before it's an assessment that in a sense is factual but it's influenced by, for instance, the appropriateness of economic equivalence considerations, substance over form, and so on. But if one person says, well my view of the facts, the document is this transaction is substantially as documented, and that reflects its commercial (inaudible 10:28:43) in substance, that's one view, and if others say, well no, that's not, it is basically smoke and mirrors as I've said, well the people who think it's smoke and mirrors would almost inevitably say and therefore it's an abusive tax position.

MR M MCKAY:

With respect your Honour, no. I think they'd then have to ask, having made my commercial and economically real assessment of what I consider this arrangement to be, taking that arrangement as I see it, is it inconsistent with Parliament's intent and purpose with respect to the specific provisions that apply to the arrangement.

WILLIAM YOUNG J:

But if the whole thing is that it is smoke and mirrors, then it's necessarily inconsistent with Parliament's intentions.

MR M MCKAY:

Look I…

WILLIAM YOUNG J:

Contemplation.

MR M MCKAY:

I think you need to ask whether those artificial and contrived elements have a link to tax outcomes which offend Parliament's tax contemplation. Sorry, which offend contemplation with respect –

WILLIAM YOUNG J:

But is that a long way of agreeing with me, that if one says it's all smoke and mirrors then wouldn't it necessarily follow that its abusive…

MR M MCKAY:

No, sorry, with respect no, because I think you still need to ask, well, does that artificiality and contrivance make a difference –

WILLIAM YOUNG J:

But can Parliamentary contemplation really encompass a smoke and mirrors arrangement that's got no economic substance.

MR M MCKAY:

Well it might, if the smoke and mirrors create an advantage offshore, and don't impact the New Zealand tax position.

WINKELMANN CJ:

I mean the problem is –

WILLIAM YOUNG J:

That's why you win the case and lost it on the appeal.

GLAZEBROOK J:

But isn't the argument rather how strong was the argument that it was not smoke and mirrors. That's what they say here, so isn't it an issue that says, I think it's smoke and mirrors, I've found it's smoke and mirrors, but how strong was the argument that it wasn't smoke and mirrors, and if it was unarguable then obviously shortfall penalties apply, and then there will be a range of almost arguable, not very arguable, substantially arguable, where there'll be different standards. In terms of the shortfall penalties, not in terms of the result. But this specifically contemplates that you might be wrong, but not very wrong, or very wrong, and then the penalties will depend on that. And the purpose and dominant purpose of course is on top of all that.

MR M MCKAY:

I think that's absolutely right. This is a case of degree that's the domain of shortfall penalties.

WINKELMANN CJ:

Yes, I think the difficulty that Justice Young and I are having accepting your argument is that if it's artificial and contrived, then the majority would be saying it's artificial and contrived and the lower court might just have, you know, you might just have got away with it. It's either artificial and contrived or it's not.

MR M MCKAY:

Yes, I think though you'd have to say even a finding here, that it's artificial and contrived, and Frucor doesn't shy from the fact that it's somewhat strange that between related parties you'd have a convertible note arrangement, but I think the next question that needs to be asked, and it is relevant to the issue of shortfall penalties, is artificiality and contrivance per se without more enough to trip the application of section BG 1, or is it necessary to link that artificiality

and contrivance to a tax advantage in New Zealand. It's Frucor's submission that –

WILLIAM YOUNG J:
But that's your position on the appeal.

MR M MCKAY:
It is –

WILLIAM YOUNG J:
Assuming that's being rejected.

MR M MCKAY:
Assuming that's been rejected I think instead of, only a factually based inquiry about whether it's artificial or contrived, you also need to ask, was it clear on the law at the time that artificiality and contrivance, per se, was enough to cause BG 1 to apply. Or was it reasonably arguable –

WILLIAM YOUNG J:
Well it never was enough per se.

MR M MCKAY:
Or was it –

WILLIAM YOUNG J:
But it was never, it would have to be artificial contrivance resulting in a tax benefit being claimed outside the contemplation of Parliament.

MR M MCKAY:
Correct.

WILLIAM YOUNG J:
Or in respect to the loss that wasn't really suffered.

MR M MCKAY:

Yes, exactly right your Honour, and I think that's what you'd have, the merits of that argument is what you'd have to assess, that despite these elements of artificiality and contrivance, what's the strength of the argument that Parliament may nevertheless have contemplated permitting deductions for tax, for interest paid by Frucor on the note. Or does Parliament require more, that those elements of artificiality and contrivance create tax outcomes which are outside Parliament's contemplation. Here Frucor says it doesn't. that these interest deductions are normative, and expected outcome in New Zealand on debt financing.

Your Honours, I'm at paragraph 27 of the submission under the heading "The Court of Appeal's approach to the standard" and I want to take you to it. We didn't go to it yesterday but I would just like to dissect it a little. It's repeated in paragraph 29. The Court of Appeal's findings are as follows, so this is after citing the *Ben Nevis* substantial merits articulation of the test, and I'm reading from the penultimate sentence of that quoted section: "While we have come to a different conclusion from the High Court on the core tax avoidance issue, we are not persuaded that Frucor's arguments could be dismissed as lacking in substantial merit."

WILLIAM YOUNG J:

But the only reason they give is that Justice Muir found in favour of them.

MR M MCKAY:

Well, yes. Well let's – no. Sorry, I won't admit that. Sorry. Let's just see what they say about Justice Muir's decision though: "Muir J, an experienced commercial Judge, not only regarded Frucor's argument as deserving of serious consideration, he explained in a careful, closely reasoned and comprehensive judgment why he was persuaded it was both factually and legally correct." In my submission, your Honours, there is something of an incorporation by reference to that decision of the arguments supporting Frucor's position. It would be, I think it's a forgivable convenience not to

repeat all of the arguments in favour of Frucor in this judgment in coming to a landing that there was substantial merit in the position taken.

WILLIAM YOUNG J:

There's not much hint of substantial merit in their analysis of the tax position though.

GLAZEBROOK J:

Well do we care what the Court of Appeal did or didn't do just in the sense that nobody is suggesting, are they, that we wouldn't have to do the exercise ourselves because there's been a cross-appeal on penalties. So it really doesn't matter if the Court of Appeal said Mickey Mouse, does it.

WINKELMANN CJ:

I think the Commissioner thinks it does because they say it's an apostasy that needs to be –

GLAZEBROOK J:

No, I totally understand the Commissioner's submissions on that, I wasn't denigrating that, but I understood it to be you have to do the exercise yourself and analyse it and it was, the Court of Appeal, whether they were led into error from relying on this High Court judgment or not, they just did it wrong, and you have to do it right.

MR M MCKAY:

Your Honour, and repeating again, it's not Frucor's submission that the mere finding in favour of –

GLAZEBROOK J:

No, no, I understand that as well.

MR M MCKAY:

But if I could just answer the point by I suppose cautioning against – well. What's the best way to put it. I don't think one can underestimate the

significance, though, of a lower court decision when regard is had to how the rest is articulated in these descriptions of the standard I took you to earlier, and I'm at paragraph 39 of the submission where I think I address this exact point and say that the lower court decision that absent some sort of manifest error, or failure to cite the right cases, or other, you know, serious misstep in logic, it will be of a high order of relevance in determining whether the "about as likely as not" standard has been satisfied because of the way the test is articulated. I'll be selective in these subparagraphs but where the relevant questions to be determined, whether (b): "The strength of the taxpayer's argument are sufficient to support a reasonable expectation that a taxpayer could win in court," or (c): "The position would be seriously considered by a court," or at (e): "Reasonable minds could differ as to which view… was correct, how can an earlier decision on the same facts and evidence not be of a high order of relevance," in determining whether the standard applies.

Then I say at paragraph 37: "That approach does not compromise an appellate court's independence. If the first instance judgment did not have the qualities it was described by the Court of Appeal," here, or by the High Court in *John Curtis,* "…it would have been vulnerable to being, and would have been, overturned on the issue of shortfall penalties."

GLAZEBROOK J:
I must say I'm not very keen either on saying that they can't have a shorthand like this, as long as they've looked at it properly, because otherwise you're going to have huge long judgments when in fact the assessment has been that the lower court judgment shows a reasonable position and that reasonable minds could differ.

MR M MCKAY:
Yes, to summarise them again would be, yes, certainly add to the length of judgments.

GLAZEBROOK J:

Well we're already telling people not to write too long a judgment, well certainly other people are telling us not to. And to impose a requirement that you have to do more than show you've put your mind to it. And then if you're wrong you can be overturned on appeal.

MR M MCKAY:

I agree with that your Honour. I'm now at paragraph 39 of the submission under the heading "A de novo assessment" and say there that even without the proof of the High Court decision in Frucor's favour, and the Court of Appeal's decision in Frucor's favour on the issue of shortfall penalties, that a fresh or ground-up assessment yields the same result in terms of the about as likely as not to be correct standard, and the Commissioner's submission, as we've heard, is that the law has not changed in any material way since the time that Frucor took its tax positions in 2006 and 2007 and that the principles to the application of section BG 1 have been more or less consistent and in particular as a result of this court's decision in *Ben Nevis*, sorry, I didn't articulate that well. No change in law in any material way as a result of this court's decision in *Ben Nevis*. Well if that's right it just means that the submissions made in respect of the substantive appeal apply equally here and I have outlined at –

WILLIAM YOUNG J:

But if they're wrong, just pause there. At 41 of your submissions you record what the Commissioner's position is. Do you take issue with any of (a), (b) or (c). I mean I know you take issue with their application to the facts.

MR M MCKAY:

I do and I was – yes. Yes I –

WILLIAM YOUNG J:

So do you say that they're wrong, that that wasn't a statement of the law's position of the law, a reasonable summary of the law as it was in 2003 or whenever…

MR M MCKAY:

I do say that your Honour. I was going to adopt that position in the first part of this section just to demonstrate how very real the arguments, even assuming the Commissioner is correct, in terms of those principles –

WILLIAM YOUNG J:

The arguments with 43 and 44 and 45 you just say the considerations don't apply here because it wasn't relevantly contrived, or wasn't a divergence and it was within the contemplation of Parliament.

MR M MCKAY:

Correct, it's a little more nuanced than just a repetition of the arguments advanced in the substantive appeal –

WINKELMANN CJ:

Well it might be helpful to us if you pinpointed what you say about 41 was wrong as at the time that the taxpayer took its position.

MR M MCKAY:

Your Honours, in that case I will move to the next section of my submission which addresses that directly, and that's the paragraphs commencing on paragraph 47 under the heading "Position at the time the tax positions were taken – pre-*Ben Nevis*" and remind the Court there that: "Section 141B(7)(b) requires that reference is had to decisions of the courts at the time the tax position was adopted," and it's Frucor's submission that at that time the *Auckland Harbour Board* decision would have been the paramount authority of relevance to Frucor's tax position addressing, as it does, the interaction between the exact rules that are engaged in the context of this dispute, and the anti-avoidance provisions. And I say that the legal principles in that case are as follows: "The intention and effect of legislation is best ascertained by reference to the words used by Parliament; and (b) anti-avoidance provisions should not be invoked as a statutory backstop as such use would amount to the imposition of tax by administrative discretion instead of by law."

Now what that decision of the Privy Council did, your Honours, is emphasised the significance of compliance with the specific provisions and give the role of each one something in the background that operated as a long stop, but what it didn't do is invoke at the same stage of the process that *Ben Nevis* does, this more general assessment of the commercial and economic reality of an arrangement. I've outlined at paragraph 49 the key directions in the quite short decision of Their Lordships in *Auckland Harbour Board* but it's probably fair to say as a summary that it is a high watermark of permissibility, structural freedoms and an emphasis on specific provisions in resolving these issues.

I say at paragraph 50 of the submission that: "The Privy Council's analysis of the relationship between specific provisions," the same ones that are engaged here, "… and s BG 1 in *Auckland Harbour Board* provided the basis for a strong rational argument that the tax position adopted by Frucor in respect of the arrangement was about as likely as not to be correct at the time." I say too that when the determinations, which we spoke about at the beginning of the submission, were combined with the directions in *Auckland Harbour Board*, that they would have given significant additional comfort that this note would give rise to deductible interest and that the debt liability would be discharged at the maturity of the arrangement through the issuance of shares by Frucor.

WILLIAM YOUNG J:
But where in the authorities is the *Auckland Harbour Board* case?

MR M MCKAY:
It is, your Honour, at the Commissioner's bundle of authorities, under tab 6, and the relevant paragraphs that I've repeated in the submission are 11 and 12. It might be surprising to your Honours that 11 and 12 are actually near the end of the judgment. But I say that the direction it gave it was one of those cases, to put it colloquially, that made an impact. That it was referred to –

WINKELMANN CJ:
Amongst tax practitioners.

MR M MCKAY:

Yes, and it was only just before my time, but yes absolutely, as indicating that when it comes to Parliament's contemplations expressed through specific provisions, that takes you a long way there in terms of the section BG 1 analysis.

WINKELMANN CJ:

What is meant by "juristic" in that passage you quote?

MR M MCKAY:

Legal I think your Honour, the legal form. Your Honours I'm at paragraph 52 –

WILLIAM YOUNG J:

Looking towards the para 14 at the end, it's a pretty short judgment commendably.

MR M MCKAY:

Yes.

WILLIAM YOUNG J:

Paragraph 14: "Mr Jenkin said that such a qualification was needed because the legislature could never have contemplated that a transfer for no consideration would give rise to a deduction. But the submission seems to Their Lordships to be contrary to several provisions of the Act, which is the appropriate place in which to discover what the legislature contemplated."

MR M MCKAY:

Sorry is that paragraph 14 you said?

WILLIAM YOUNG J:

Yes, but it's not a rejection of the legislative contemplation test, it's simply saying that applying it here in this particular context you get a particular answer, isn't it? It's so succinctly written it's a bit cryptic.

MR M MCKAY:

Yes, your Honour, in a sense, and just a reminder of the facts there, it was the Auckland Harbour Board was in possession of bonds and government stock that it then created two trusts, I think they may have been charitable trusts. It then effectively gifted, or sold for no consideration, those stocks and bonds to those two trusts. Giving rise unto the financial arrangements rules, or accrual rules as they then were, and as they were then drafted, a deduction for the full cost of those stocks and bonds on the basis that the rules didn't require market value transfers, didn't require that Auckland Harbour Board acted rationally with respect to valuing those instruments when they transferred it to a trust, and it gave rise to a very substantial deduction.

WILLIAM YOUNG J:

But they're not saying that it's, I mean I know, I mean what pervades the judgment is a particular approach to tax avoidance, but it's expressed in a way that isn't really inconsistent with *Ben Nevis*.

MR M MCKAY:

No, not in a sort of obvious – sorry. Not in a direct level your Honour, but in terms of the outcome what it does do, and taking that factual background in mind, it says compliance with the specific provisions, tick, and then it really doesn't leave much room in that factual scenario for a valuation of market norms by reference to third party standards or norms. It's, in my respectful submission Sir, a very black letter approach.

WILLIAM YOUNG J:

Well it's, I mean I'm looking at the middle of 11: "Their Lordships do not of course suggest that the two sections," that's the anti-avoidance sections specific in section 99, "… necessarily cover the ground, but what they have in common is that they are, generally speaking, 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 it meant by defeating the intention and application of the statute." Well that could have come out of *Ben Nevis*.

MR M MCKAY:

Yes your Honour, but then when we get to the end of that paragraph –

WILLIAM YOUNG J:

Just that they find it, they don't apply them quite the same way as we might now.

MR M MCKAY:

That is correct your Honour.

WILLIAM YOUNG J:

It is an attitudinal shift.

MR M MCKAY:

And I think coupled with the direction that you can't use BG 1 to smooth over the gaps.

WILLIAM YOUNG J:

But that's one view, there were other views around. I know you say well only one view is enough but the view that section BG 1 is just a backstop was not really an orthodox view…

MR M MCKAY:

It was the direction of the Privy Council at the time your Honour, in respect of the very provisions engaged with respect to this arrangement.

WINKELMANN CJ:

Well what do you say about…

MR M MCKAY:

Peterson?

WINKELMANN CJ:

Yes.

MR M MCKAY:

I say *Peterson* has never been referred to as other than a very good win for the taxpayer.

WINKELMANN CJ:

Well, yes, but that still establishes law.

MR M MCKAY:

Yes, I also say that it doesn't in the same way as *Auckland Harbour Board* engaged this difficult relationship between specific provisions and the general anti-avoidance provision. It is, your Honour, in my submission, a little hard to derive from that judgment much of probative value in a section BG 1 inquiry. It's not as explicit about its view on the relationship between specific provisions and the avoidance of provisions. It doesn't do what this judgment does and *Auckland Harbour Board* addressed the same specific provisions, and there was a very vehement dissent, 3-2, which also caused it to be of difficult value in advising.

WINKELMANN CJ:

Well I don't think – why?

MR M MCKAY:

And I think it was regarded as a bit of an outlier your Honour.

WINKELMANN CJ:

It's the law though.

MR M MCKAY:

Along with *Auckland Harbour Board*, which when it applies as it does here to the very specific provisions engaged, is the one you'd go to.

WINKELMANN CJ:

Well the one you'd go to.

MR M MCKAY:

Not the one I did go to, but the one I would go to at the time.

WINKELMANN CJ:

Yes. So there's a bit of people reading what they want to see, is what you're saying?

MR M MCKAY:

No, I wouldn't say there's something for everybody in this caste of Privy Council decisions. I would say *Auckland Harbour Board* is a better quality decision. One that gives more specific direction in terms of the very difficult issue we've been facing from the beginning on this, in that BG 1 is expressed in such broad language that it must be curtailed in some sense to allow the specific provisions within the Act, conferring as they do, within Parliament's contemplation, benefits on taxpayers, that we need –

WILLIAM YOUNG J:

Are they benefits, are the benefits that have been taken by the taxpayer within the contemplation of Parliament as being a legitimate resort to those provisions. Now that I think probably was, I think the Privy Council in the *Auckland Harbour Board* case would have accepted that that was a legitimate approach.

MR M MCKAY:

Yes.

WILLIAM YOUNG J:

There the intention and purpose of Parliament was specific to the accrual regime in that case?

MR M MCKAY:

That's correct. Which is the financial arrangements regime, accrual rules renamed, that are applicable to the note arrangement here. And they are saying, and not to go back to the substantive discussion in any substantive

way, but when we take the context of the accrual rules, or financial arrangements rules, and know that what they do is the difficult task of identifying what is finance and what is debt, what is equity, what's something in between, and at the bottom of all that, whether it even matters in terms of whether there's interests, costs and expenditure because of the time value of money, I think the direction here is that those rules have done a lot of the work, they are probably, no I say probably, they are more explicit in terms of Parliament's contemplation than many of the other specific provisions of the Act. Doing what they do in a very comprehensive way, with anti-avoidance at the base of them all.

Your Honours, in case it's convenient, at paragraph 57 I've included a timeline there showing the filing dates of Frucor's tax position. Sorry, filing dates for tax returns which are the dates that relevant tax positions are taken in terms of the statutory analysis and shortfall penalties, and the release date of *Auckland Harbour Board* and *Ben Nevis*.

ELLEN FRANCE J:
Sorry could I just check. In terms of *Accent Management Ltd v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21,323 in the Court of Appeal am I right that that comes before the 2007 return as filed?

MR M MCKAY:
Your Honour, I'm almost sure that's correct.

O'REGAN J:
There's a lot of nodding going to your right.

MR M MCKAY:
Yes, there's nodding, I'm, not sure I'm 100% confident of that. Yes, thank you, I'll take your word for it. Yes, before the 2007 return but not the 2006, and your Honour it was subject to appeal almost immediately as you know. I think people were still waiting for this court's direction in *Ben Nevis*.

GLAZEBROOK J:

And you'd argue anyway, presumably on that basis, that it was the Supreme Court decision in *Ben Nevis* that changed the approach in any event.

MR M MCKAY:

That's correct your Honour. In doing what it did and saying rather than mere long stop, section BG 1 is to be given the same weight as specific provisions, have tandem operation and be of equal status in the analysis.

WILLIAM YOUNG J:

Did *Ben Nevis* say that the approach to the avoidance provision, that is that it wasn't a long stop, was novel or did they say it was there in the authorities all the time?

MR M MCKAY:

I appreciate that reminder your Honour. Could I take you back to paragraph 52 and 53 of my submission, and I say there that the Commissioner's argument that these cases had more or less carried along consistently in the years prior to *Ben Nevis*, is difficult to reconcile with comments in *Ben Nevis* itself. I'm at paragraph 53 of the submission. "The Supreme Court in *Ben Nevis* noted that the *Auckland Harbour Board* decision appeared to have placed 'significantly less emphasis on the application of the general anti-avoidance provision' than the prior leading cases. The Supreme Court considered that as a result *Auckland Harbour Board* had contributed to 'continuing uncertainty as to the interrelationship of the general anti-avoidance provision with specific provisions' in suggesting that the role of s BG 1 may be as a 'long stop'."

WILLIAM YOUNG J:

In *Auckland Harbour Board* there was no pretence or contrivance. It was basically a clean deal, wasn't it, it was what it all meant. I mean the real purpose would appear not to have been tax avoidance but rather to thwart the restructuring.

MR M MCKAY:

(inaudible 10:57:50)

WINKELMANN CJ:

I think your microphone might be off.

MR M MCKAY:

(inaudible 10:57:55)

WINKELMANN CJ:

Just pause. I think the microphone is off.

MR M MCKAY:

(inaudible 10:58:10)

GLAZEBROOK J:

It's very muted. Because you seem to be speaking at a normal…

MR M MCKAY:

(inaudible 10:58:25)

WILLIAM YOUNG J:

I don't think it's working.

GLAZEBROOK J:

It's coming across as a whisper.

MR M MCKAY:

(inaudible 15:58:30)

COURT ADJOURNS: 10.58 AM

COURT RESUMES: 11.16 AM

MR M MCKAY:
Your Honours, I had two points remaining. I'm at paragraph 58 of the written submission under the heading "The Commissioner's alternative theories".

WILLIAM YOUNG J:
Can I just go back to 41 of your submissions?

MR M MCKAY:
Sure.

WILLIAM YOUNG J:
Which of (a), (b) and (c) do you disagree with accurately stating the law?

MR M MCKAY:
The most –

WILLIAM YOUNG J:
Do you say it was not well settled that section BG 1 would apply for a transaction where there was pretence, artificiality or contrivance?

MR M MCKAY:
Yes, I would.

WILLIAM YOUNG J:
You accept that?

MR M MCKAY:
Sorry, pardon?

WILLIAM YOUNG J:
Do you accept that or disagree with it?

MR M MCKAY:

Sorry that BG 1 would apply if there was artificiality and contrivance?

WILLIAM YOUNG J:

Sorry, do you accept what Mr Smith said, that the propositions (a), (b) and (c) which I guess have to apply read together accurately state the position in say 2001/2002?

MR M MCKAY:

No I don't accept that your Honours.

WILLIAM YOUNG J:

So do you say *Auckland Harbour Board* is the exception. Is there any other, is a word derogation from those principles?

MR M MCKAY:

Well I would've before yesterday cited *Peterson* as one of the decisions.

WILLIAM YOUNG J:

Okay.

MR M MCKAY:

Which would have buoyed a taxpayer in taking a view based mainly on the operation of specific provisions.

WINKELMANN CJ:

So you're saying you don't agree that any of the propositions were well settled or…

MR M MCKAY:

I regard them as important parts of the analysis, so my submission is that *Auckland Harbour Board* created a different emphasis in terms of the relationship between specific provisions and the anti-avoidance provisions but no I mean it's possible to trace, in one way or another, each of those principles described there to cases that preceded *Auckland Harbour Board*,

but the significant point in *Auckland Harbour Board* is really the weighting to be given to what became the first and second stage in the *Ben Nevis* analysis.

WINKELMANN CJ:
But *Auckland Harbour Board* itself says that a critical consideration is (b) there was a divergence between the commercial economic reality of arrangement and the form adopted, doesn't it?

MR M MCKAY:
Yes it does.

WILLIAM YOUNG J:
And on that case there was absolutely no divergence.

MR M MCKAY:
Well that is where Their Lordships landed, a sale for nothing is, yes, that is correct.

WILLIAM YOUNG J:
It wasn't pretending to be something else.

MR M MCKAY:
No, but what that does indicate is a very black letter approach to the operation of the accrual rules of the time, financial arrangements rules now.

I was at paragraph 58 under the heading "The commissioner's alternative theories" and I say at paragraph 58: "A further indication that the tax positions taken by Frucor were at least about as likely as not to be correct is demonstrated by the contradictory positions taken by the Commissioner during the course of this dispute."

Your Honours the, Frucor has faced two views advanced by the Commissioner of the commercial and economic reality, the arrangement over time. The first is the Deutsche Bank net loan theory, which is before

your Honours, but a second set of assessments were issued following the conclusion of the disputes resolution procedure, which took a different view of the commercial and economic reality of the arrangement. That alternative view –

WINKELMANN CJ:
And it was put forward as an alternative view, wasn't it? It's expressed as an alternative view?

MR M MCKAY:
In a letter accompanying the assessments made in respect of that alternative view.

WILLIAM YOUNG J:
But there were alternative views available in *Ben Nevis*. I mean you could reach the view basically that the tax scheme didn't work, but there are a number of possible reasons why it didn't work.

MR M MCKAY:
I would argue that the position is somewhat different here, because it's impossible, in my submission, to reconcile the alternative views. They are very different views of the commercial and economic reality of the arrangement.

WILLIAM YOUNG J:
But I mean they're different in *Ben Nevis*, because there were a whole series of attempts to re-open it on the basis that this tax scheme didn't work at all and therefore section BG 1 wasn't engaged. But I mean they were inconsistent theories.

MR M MCKAY:
I think –

WILLIAM YOUNG J:

And perfectly arguable.

MR M MCKAY:

Well, yes, and in a sense that's my point. If we do have different views advanced by the Commissioner of the economic and commercial reality of the arrangement, and being as fundamentally different as they are, and just a reminder if I may what those alternative assessments were, that assumed that the view of this arrangement had 55 million coming in from Deutsche Bank. Frucor issuing a deeply discounted debt bond to is parent DAP, which was repaid on maturity for 204. Now that occasion says when under the financial arrangements rules, a deduction to Frucor of 55 million, which combined with the 11 million under the net loan from Deutsche Bank, gave rise to 66 million of deductions that –

WILLIAM YOUNG J:

But presumably it produced an income somewhere, it produced a liability of equal and equivalent liability somewhere.

MR M MCKAY:

Well it would've under the Commissioner's alternative view of the arrangement

WILLIAM YOUNG J:

Yes.

MR M MCKAY:

But what it would have done, critically, in terms of New Zealand tax contemplation, and New Zealand's anti-avoidance provision, is give rise to full deductibility but a withholding tax cost on the interest that was paid under that deeply discounted bond by Frucor to its parent on maturity.

WILLIAM YOUNG J:

And the net economic effect, would that have been the same, or not? In terms of cash?

MR M MCKAY:

Your Honour, it would have had, not in terms of quantum. It would have had a far reduced quantum, withholding tax being charged at 15% I think to Singapore of the $55 million interest. So no quite considerably less than the interest deduction denial assessments which are before this court now.

WILLIAM YOUNG J:

So it's the difference between 33 cents in the dollar and 15 cents in the dollar.

MR M MCKAY:

That's correct your Honour, yes. That is the difference.

WINKELMANN CJ:

Your point is?

MR M MCKAY:

My point is, and why this is relevant in a shortfall penalty context, is that the Commissioner saw her NRWT and NRWT abusive tax position penalty assessment, which was issued with respect to that view of the arrangement, as being sufficiently likely to succeed to take the step of issuing those assessments, and look no issue is now taken about whether either set of assessments are valid. I mean in 2017 the NRWT and NRWT shortfall penalty assessments were withdrawn by the Commissioner, but it is relevant that the nature of an assessment, it's really an invoice issued by a revenue authority stating the amount owed, when it's due for payment, and if it's not paid on that date, imposing the use of money interest. It's something that must be other than conditional or –

WINKELMANN CJ:

So what, you're saying that the Commissioner coming up with an alternative view itself shows, there's evidence that it was an arguable position?

MR M MCKAY:

Yes.

WINKELMANN CJ:

Okay.

WILLIAM YOUNG J:

Clearly that happened in *Ben Nevis*, wasn't there more than one basis of assessment advanced?

MR M MCKAY:

Well I think on technical points, but not on a fundamentally different view of what the commercial and economic reality of the arrangement is. I know that at the specific provision stage of *Ben Nevis* there were a number of alternative challenges to whether certain specific provisions had been met or not, which was really the basis of the minority's decision in that case, but what the Commissioner never said in that case is that okay I'm advancing two different views here of what I think this is in commercial and economic terms.

WILLIAM YOUNG J:

I'm not sure about that. I think there might have been a different view, but anyway I can look at the judgments.

MR M MCKAY:

Your Honours, I am now at paragraph 69 under the heading "Shortfall penalties do not have automatic application in a s BG 1 context". Now it's probably an obvious submission so I won't spend very long on it but I've elaborated on it in the written submissions on the basis that I think the Commissioner's submission does risk inferring that it could or should have automatic application here. I've set out that there's in some sense something

inconsistent with the Court of Appeal's finding that section BG 1 applied but that shortfall penalties did not. It's Frucor's submission they're just different tests.

WINKELMANN CJ:
What paragraph are you at sorry?

MR M MCKAY:
I was under the heading "Shortfall penalties do not have automatic application" at paragraph 69 and following in the written submission.

WINKELMANN CJ:
Thank you.

MR M MCKAY:
It goes back to an earlier point –

WINKELMANN CJ:
Yes I don't think Mr Smith – Mr Smith, I think, did expressly eschew that proposition.

MR M MCKAY:
I'm then, your Honours, in the final section of the submission dealing with section 141D, that's the abusive tax position penalty, which is at paragraph 74 and following, and say there that: "In addition to being an unacceptable tax position, for an abusive tax position in s 141D to be found it must also be demonstrated that, viewed objectively, the 'dominant purpose' of the arrangement was 'avoiding tax'".

And I've set out at paragraph 76 the original discussion document in relation to shortfall penalties, which discusses two approaches to the abusive tax position penalty. One, where there would be automatic application in a tax avoidance context, and the other where something more is required than a mere finding that section BG 1 applies, and it's the second of those

approaches that was favoured in the legislation. That is that there must be something more, there must be blatant or abusive tax avoidance, rather than a mere finding that section BG 1 applies, and that's all represented by the additional dominant purpose threshold.

I say at paragraph 81 of the submission, I take there the meaning of "dominant purpose" from the High Court of Australia decision in *Federal Commissioner of Taxation v Spotless Services Ltd* [1996] ATC 5,201 (HCA) which considered the application of the Australian anti-avoidance provision which requires a dominant purpose of tax avoidance, and taking that test: "In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose."

Then say at paragraph 84 of the submission, the dominant purpose of this arrangement at its highest level was to introduce more debt into Frucor's balance sheet within the capitalisation limits.

I say at paragraph 85 that: "If the Commissioner is to frame the question as what was the ruling, prevailing or most influential purpose of the specific form of the arrangement involving the Note and Forward Purchase, the response is the non-inclusion of income under the arrangement in Singapore."

Now I say at paragraph 86, that the correctness of this proposition is revealed by a before and after comparison of the level of deductions claimed under the cash management facility and this arrangement, and that if tax deductions in New Zealand had been the focus of it, the dominant purpose of it, you wouldn't get to a near identical position in terms of the interest deductibility. A focus on interest deductibility in New Zealand doesn't reveal why the status quo position was departed from.

Your Honours that, unless there are questions, formally concludes the, we are the respondent in this case, submissions on shortfall penalties.

WINKELMANN CJ:

Thank you. Mr Smith.

MR SMITH QC:

If your Honours please, I have nothing in reply.

WINKELMANN CJ:

Does anyone have any questions for Mr Smith? Thank you. Counsel, thank you for your very helpful submissions. We will take time to consider our decision.

COURT ADJOURNS: 11.31 AM