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WEEKLY COMMENT: FRIDAY 13 JUNE 2014

1. Last week and the week before that I looked at the four scenarios in Inland Revenue's recently released draft Question We've Been Asked *Income tax: scenarios on tax avoidance* ("the draft QWBA") with a deadline for comment of 4 July. This week I continue with the theme of tax avoidance and look at the decision, released on 16 May 2014, in the Taxation Review Authority case *TRA 001/13* [2014] NZTRA 04. The case makes for interesting reading in relation to dividend stripping, countering the tax advantage and shortfall penalties.

The facts of the case

2. Mr. & Mrs. G were the directors and shareholders of 2 companies: "Holdings", which operated Mr. G's profitable professional practice, and "Specialists", which operated a separate business venture and had accumulated tax losses. The following facts are relevant:
   (a) Holdings had retained profits of $1.8m and insufficient imputation credits to attach to dividends;
   (b) Mr. G owed Holdings $1m as reflected in his overdrawn current account; and
   (c) Specialists owed Holdings a debt of $1.9m.
3. In a series of transactions commencing from November 2006:
   (a) Mr. G sold some of his shares in Holdings to Mrs. G at a valuation provided by his tax consultant, so that Mr. and Mrs. G each ended up with 50% of the shares in both Holdings and Specialists, allowing the tax losses of Specialists to be offset against Holdings' profits from the 2008 tax year inwards;
   (b) The debt owed by Specialists to Holdings was capitalised, and Holdings ended up with $1.9m of shares in Specialists instead of the debt owed by Specialists (in view of Specialist's accumulated tax losses, question whether this itself would be classed as avoidance in terms of Scenario 4 in Inland Revenue's draft QWBA discussed last week);
   (c) Mr. & Mrs. G incorporated a new company, "Group", and sold their shares in Holdings to Group at the same price as some of Mr. G's shares had been sold to Mrs. G earlier;
   (d) The consideration owed by Group to Mr. & Mrs. G was $1.8m which was recorded in Groups' financial accounts as an on demand loan from Mr. & Mrs. G;
   (e) Group assigned $950k of the loan from Mr. & Mrs. G to its new subsidiary, Holdings, so that Group owed Holdings $950k;
   (f) Holdings set off the $950k debt owed to Mr. and Mrs. G against the current account balance owed by Mr. G.

4. There were also some other much smaller transactions to "sweep up" the remaining amount owed by Mr. G in his current account with Holdings. The effect of the above transactions was that Mr. G's overdrawn current account balance was eliminated against the purchase price for the shares in Holdings paid by Group. The balance of $522k remained outstanding as a loan owed by Group, allowing further profits sheltered by Specialists' tax losses to be distributed tax-free to Mr. & Mrs. G.

Tax avoidance arrangement: dividend stripping

5. The Commissioner alleged that there was a tax avoidance arrangement, and apparently Mr. & Mrs. G agreed. The arrangement involved a "dividend strip".

6. Dividend stripping is covered in s. GB 1, which applies when a person disposes of shares as part of a tax avoidance arrangement and some or all of the proceeds are equivalent to a divided that the person might have instead derived. The amount derived in substitution for a dividend is treated as a dividend.

7. There are only two cases of dividend stripping that have previously been considered by the New Zealand courts: *Case B36* (1976) 2 NZTC 60,297 and *Case P34* (1992) 14 NZTC 4,247.

8. In this case, the Commissioner treated the purchase price paid by Group for Holdings' shares as a dividend to the amount of Holdings' retained profits of around $1.7m, and assessed Mr. & Mrs. G for half of the dividend each.

Arguments that the "dividend reconstruction" was incorrect

9. Mr. & Mrs. G argued that the Commissioner incorrectly exercised the reconstruction powers in s. GA 1 to create tax liabilities when there are no tax advantages to be countered. They argued that the effect of ignoring the transactions was that the current account owed by Mr. G to Holdings (and other smaller amounts owed to Specialists) remained in place – i.e. the current accounts were "reinstated" and were not eliminated. Therefore, there was no dividend as no value had been transferred from the companies to Mr. & Mrs. G.

10. With the current account(s) having been reinstated, Mr. & Mrs. G argued the remaining amount of the purchase price owed by Group to them – being $522k – was available for repayments of amounts to them in future.

11. In particular, Mr. & Mrs. G argued:

    (a) The initial overdrawing of the current account was not part of the tax avoidance arrangement, therefore, the overdrawn current account balance was not "void as against the Commissioner";

    (b) The ensuing arrangement to eliminate the current account balance was a tax avoidance arrangement, therefore the ensuing arrangement is ignored (and the current account is reinstated);

    (c) The disposal of the shares in Holdings to Group was part of the tax avoidance arrangement, and is therefore void as against the Commissioner, and the transaction must be ignored;

    (d) Once the sale of shares is ignored, there can be no consideration and, consequently, no dividend; and

(e) In any case, the retained profits were not able to be paid as a dividend because they were funding the assets of Holdings.

12. The Commissioner argued that the only way Mr. G could have discharged his historic liability to Holdings in the form of the overdrawn current account was to have money transferred from Holdings to him, and this was also necessary to maintain the pattern of drawings. To support the treatment of the retained earnings as dividends, the Commissioner argued that:

    (a) As a result of the restructuring, the retained profits of Holdings are no longer available to be paid as dividends to Mr. & Mrs. G;

    (b) The balance of the purchase price of $522k remained available for future tax-free distributions, and it was the Commissioner's prerogative to counter that advantage;

    (c) A release of debt is a transfer of value and, therefore, a dividend: In *Case Q49* (1993) 15 NZTC 5,254, Judge Willy found that a transaction involving the debiting of the capital account and crediting of the shareholders current account and loan accounts does give rise to a deemed dividend, and he quoted several other cases as authorities for this proposition;

    (d) In *Case Z4* (2009) 24 NZTC 14,057, Judge Barber noted that the concept of what is a dividend for income tax purposes is broader than what constitutes a distribution for the purposes of the *Companies Act 1993*.

The judge's decision

13. Section BG 1(1) states that:

    "A tax avoidance arrangement is void as against the Commissioner for income tax purposes."

14. The judge noted s. BG 1 is "a destructive provision. It does not itself create a liability for income tax." The Privy Council's comments in *Newton v FCT* [1958] AC 450 [467] about the equivalent Australian provision were quoted:

    "… In the words of the courts of Australia, it is an "annihilating" provision – the commissioner can use the section so as to ignore the transactions which are caught by it. But the ignoring of the transactions – or the annihilating of them – does not itself create a liability to tax. In order to make the taxpayers liable, the commissioner must show that moneys have come into the hands of the taxpayers which the commissioner is entitled to treat as income derived by them…"

15. Section BG 1(2) states:

    "Under Part G (Avoidance and non-market transactions), the Commissioner may counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement."

16. Section GA 1 applies if an arrangement is void under section BG 1 and s. GA 1(2) states:

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

17. Section GA 1(4) is headed "*Commissioner's identification of hypothetical situation*" and states that when applying the adjustment provision, the Commissioner may have regard to income, deductions, tax losses or tax credits which, in the Commissioner's opinion, had the

arrangement not occurred, the person would have had or would in all likelihood have had or been expected to have had.

18. However, the Commissioner does not have to base the adjustment on a hypothetical arrangement that the taxpayer may have entered into in the absence of the tax avoidance arrangement. This was made clear recently in *Alesco NZ Ltd v Commissioner of Inland Revenue* (2013) 27,047 and earlier in *Accent Management Limited v Commissioner of Inland Revenue* [2007] NZCA 230, (2007) 23 NZTC 21,323 (CA) where the Court of Appeal said:

    "The counter-factual envisaged by s GB 1 … is the position "if that arrangement had not been made or entered into". There is thus no need for the Commissioner (or the Court) to conjure up an alternative and more effective scheme into which the taxpayers might have entered."

19. In this case, Judge Sinclair found that section BG 1 voids the tax effect of the arrangement, but does not void the underlying transactions. The judge agreed with the Commissioner that:

    (a) Mr. & Mrs. G would have had to have money transferred from the company to clear the current account deficit;

    (b) It was the Commissioner's prerogative to counter the tax advantage arising from the balance of the purchase price of $522k remaining available for future tax-free distributions;

    (c) It did not matter whether the company could in fact pay out the retained earnings as dividends: "… income tax law is entirely unconcerned with whether a company is able to make a payment of a dividend, and treats the concept of a dividend as much wider than a mere monetary distribution to a shareholder".

Shortfall penalties

20. The Commissioner had imposed shortfall penalties for taking an abusive tax position – i.e. a tax shortfall exceeding $20,000 in relation to an unacceptable tax position taken in respect of an arrangement entered into with a dominant purpose of avoiding tax (s 141D of the *Tax Administration Act 1994*).

21. Mr. & Mrs. G argued that they could not have known about the deemed dividend until the Commissioner had reconstructed the arrangement. A shortfall arising from comparing the tax return position with the artificial construct of taxable income made by the Commissioner is beyond the plain meaning of the term "shortfall" and Parliament would have used more specific language had it intended such a result.

22. The judge disagreed: "In my view Parliament clearly envisaged that the exercise of the Commissioner's powers under s GB 1 … would likely result in a taxpayer facing a "tax shortfall" and a shortfall penalty".

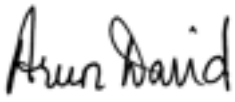
23. The judge found that the correct position was that Mr. & Mrs. G should have returned the deemed dividends in their tax returns.

24. Mr. & Mrs. G contended that Parliament did not intend a disputant who has acted upon professional advice to second guess the views of the tax advisor. The judge noted that the acceptance of professional advice did not immunise Mr. & Mrs. G from a statutory liability for shortfall penalties, and the fact that that the advice was positive did not make it correct.

No "external ownership" resulting from the restructure

25. In a number of recent cases, the Commissioner has implied that a "genuine" restructure requires the introduction of some external ownership or an effective change in the overall ownership of a company. The same argument was made in this case: the Commissioner pointed to "lack of economic cost and minimal financial consequences to the disputants who retained 100% ownership and control of the companies before and after the restructuring".

26. It would be wise to review "internal" restructures very carefully for avoidance implications in view of these contentions by the Commissioner.



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