KPMG

Case Summary

Cullen Group Ltd v Commissioner of Inland Revenue
[2019] NZHC 404

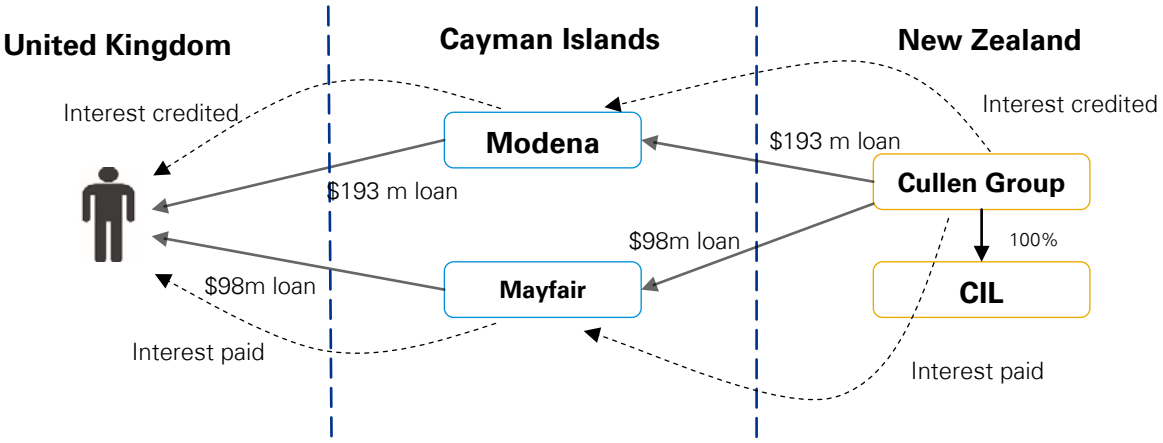
March 2019

The High Court has ruled that the Eric Watson controlled Cullen Group used a "web of entities" to avoid paying non-resident withholding tax of 15% on loans to other Watson controlled entities in the Cayman Islands, instead paying the Approved Issuer Levy rate of 2%. We set out the facts below, followed by the highlights of the High Court's decision.

The facts

1 Eric Watson moved from NZ to the UK in 2002. He divested himself of his NZ ties, and restructured his business affairs so that shares he owned in Cullen Investments Ltd ("CIL") (independently valued at $291m) were replaced by loans owed by Cullen Group Ltd ("Cullen Group") to conduit companies in the Cayman Islands, Modena Holdings Ltd ("Modena") and Mayfair Equity Ltd ("Mayfair"). Watson no longer wanted to be a NZ tax resident, and sold his property and a number of other assets, as well as disassociated himself from clubs and associations in NZ.

2 The restructure involved a complex network of entities and effectively resulted in Mr Watson exchanging his equity in CIL for a debt to the same value from CIL's new owner, Cullen Group (which Mr Watson ultimately controlled through a series of holding companies and trusts). The debt was held through the conduits, Modena and Mayfair, who were legally not associated persons of the Cullen Group. The new structure was shown in the judgement as follows:



3 The terms of the loan agreements meant that Mr Watson could call for repayment from Modena and Mayfair, and only then could Modena and Mayfair call for the debt from Cullen Group. The arm's length interest rate, and terms of the loans from Cullen Group to the conduits, and then from the conduits to Watson were, to all intents and purposes, the same.

4 The Cullen Group applied for and obtained Approved Issuer Levy ("AIL") status, paying the 2% AIL rate on the interest paid to Modena and Mayfair, compared with the 15% NRWT rate. $8m AIL was paid during the relevant period. The Commissioner of Inland Revenue ("Commissioner") re-assessed the Cullen Group for the difference between the AIL paid, and what would have been paid if NRWT at 15% was due (being $51.5m) on the basis that the arrangement was a tax avoidance arrangement under sBG 1.

Result

1 Cullen Group's challenge was dismissed.

2 Cullen Group is liable to pay the $51.5m of tax as assessed, plus use of money interest and penalties.

The judgment

1. The *Ben Nevis* approach to tax avoidance arrangements

The Court applied the three requirements outlined in *Ben Nevis*. Both parties agreed that the first requirement, that there be an arrangement, was met. The second requirement, that the specific provisions (being the use of the AIL regime) were used in a way which cannot have been within Parliament's contemplation, was contested and required a greater level analysis, with the Court ultimately holding the use of the AIL regime by the Cullen Group in this way was not within Parliament's contemplation (further analysis below). The third requirement, whether or not the effect of the arrangement was to alter the incidence of tax to merely incidental extent was contested between both parties, with the Court agreeing with the Commissioner.

2. The AIL regime is not able to be used by "associated persons"

The Court outlined the use of NRWT compared with AIL, emphasising that under the AIL regime a New Zealand borrower who is an "approved issuer" may pay AIL at 2% on interest paid, in relation to a "registered security", to someone who is not an "associated person". Modena and Mayfair were not legally "associated person[s]" of the Cullen Group, so the Cullen Group could, on the black letter law, rely on the AIL provisions.

3. The creation of a web of entities <u>may</u> still lead to an individual being an "associated person"

Although the Commissioner accepted that Cullen Group was not, legally, an "associated person" of Modena or Mayfair, and did not control them for the purposes of s OD 7 of the Income Tax Act 1994 (the associated persons test), the judgement suggested that an individual may still be held to be an "associated person" in these circumstances. The Court, in obiter, considered the relevance of sOD 7(1)(a)(iii) and whether entities may have been associated persons on the basis that there existed a group of persons "who have control of both companies by any other means whatsoever". However, the Court accepted that the Commissioner was bound by her pleadings and that therefore sOD 7(1)(a)(iii) could not be applied in this case.

4. The way in which the Cullen Group used the AIL regime was not within Parliament's contemplation

Counsel for Cullen Group contested that whether a specific provision is used in a way that is not within Parliament's contemplation must be firmly grounded in the statutory language. The Commissioner submitted that Parliament's intention is that the concessionary AIL rate is only available to "genuine overseas third party lenders" where there is not a high degree of common control and ownership. The Commissioner submitted that this arrangement could not have been intended to benefit from the 2% AIL rate due to a number of factors:

- No genuine overseas investment from a genuine non-resident lender
- The parties were subject to a high degree of common control
- Many features of the loans and transactions were commercially unorthodox

Both parties to the dispute agreed that the use of the AIL regime fell within specific provisions. The Court considered the arm's length principle in light of the complex ownership structure, and whether the transaction was artificial. In contrast to other tax avoidance cases, the arrangement lacked features of artificiality and contrivance such as the non-commerciality or the interest rate, a contrived management fee but the Court ultimately held that neither the lender nor the borrower were independent, on the basis that Mr Watson maintained a high level of control over both sides of the transaction.

In essence, the ownership and debt relationships were structured in order to allow Mr Watson, through Cullen Group in New Zealand, to pay AIL at 2% rather than NRWT at 15%. The Court then went on to consider whether Parliament contemplated entities using AIL instead of NRWT in such a circumstance. The Court held (agreeing with the Court of Appeal in *Vinelight*) that the objective of the AIL regime is to encourage investment in New Zealand by reducing the cost of borrowing from non-residents.

The Court held that the restructure was one of form, but not substance. Mr Watson retained a high degree of control over the entities. Although the arrangement fell within the specific AIL provisions, use of the AIL regime in this arrangement was not within Parliament's contemplation.

5. Relocating to a new jurisdiction does not amount to tax incidence alteration being merely incidental

The Court held that the arrangement clearly used the specific provisions of the ITA to alter the incidence of tax. In considering whether the tax consequences were merely incidental, the Court considered the purpose behind the restructuring of CIL's ownership in giving effect to Mr Watson's migration to the UK. The Court accepted that part of the purpose could have been to allow Mr Watson a source of "clean capital" for UK remittance planning purposes.

However, the Court concluded that the payment of AIL was a key element of the loans between Cullen Group and Modena and Mayfair. Therefore, Cullen Group was unable to show that the altering of the tax incidence was merely incidental.

6. Should the Commissioner have been time-barred?

Under s 108 of the Tax Administration Act 1994, a four-year time bar is placed on the Commissioner's ability to alter an assessment. The assessment was made outside the four-year limitation period, however, the Court held that it was not time barred on the basis that it was not income tax as required under s 108.

Contact KPMG's Tax Dispute Resolution & Controversy Services team

If you have any questions about the above, please contact KPMG's Tax Dispute Resolution & Controversy Services team. In the first instance, contact Andrew Tringham at atringham@kpmg.co.nz or alternatively, Bruce Bernacchi at bbernacchi@kpmg.co.nz.

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