CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

DavidCo Limited
CHARTERED ACCOUNTANTS

Level 2, Shortland Chambers
70 Shortland Street, Auckland
PO Box 2380, Shortland Street
Auckland 1140
T +64 9 921 6885
F +64 9 921 6889
M +64 21 639 710
E arun.david@davidco.co.nz
W www.davidco.co.nz

WEEKLY COMMENT: FRIDAY 10 APRIL 2015

1. This week I leave GST and swing back into the area of income tax. I look at the proposals in *Related parties debt remission – An officials' issues paper* ("the Issues Paper") released on 24 February and QB 15/01 – *Income tax; tax avoidance and debt capitalisation* attached as an Appendix to the Issues Paper and published in Tax Information Bulletin Vol. 27 No. 3, April 2015 from page 25.

2. The proposals aim to do away with debt remission income that arises on certain related party transactions under current law. Inland Revenue has stated in paragraph 1.9 of the Issues Paper that, pending the outcome, it will not chase debt remission income on the related party transactions covered by the proposals, even though QB 15/01 concludes that capitalisation of debt in such situations could amount to tax avoidance.

3. This week I look at debt remission scenarios and QB 15/01. Next week I will look at the proposals in the Issues Paper.

Debt remission scenarios

4. Under the financial arrangements rules, a base price adjustment ("BPA") is required and income will potentially arise in the following situations:

   (a) When a party to a financial arrangement is discharged from making all remaining payments under the arrangement without fully adequate consideration: s. EW 29(9);

   (b) When a party to a financial arrangement is discharged from making all remaining payments under the arrangement under the Insolvency Act 2006 or the Companies Act 1993 or similar laws of a foreign country: s. EW 29(10);

   (c) When a party to a financial arrangement is released from making all remaining payments under the arrangement by a deed or agreement of composition with the party's creditors: s. EW 29(11);

   (d) When all remaining payments under the arrangement become irrecoverable or unenforceable through the lapse of time: s. EW 29(12);

   (e) When the creditor sells the debt to a person associated with the debtor and at a discount in the circumstances described in s. EW 43 (i.e. the debt is sold for 80% or less of the market value of the debt determined as if the creditworthiness of the debtor had not declined), in which case the debtor is treated as having paid the amount paid to the creditor: s. EW 29(8).

5. In relation to the above, it is noted that:

   (a) When the debtor is released by operation of law as described in paragraph 3(b), the rules are avoided because the remission is deemed to happen immediately after the liquidation is finished and there are no assets to pay the tax;

   (b) The "debt parking" rules described in paragraph 3(e) were introduced to stop avoidance of the tax liability by buying and "freezing" a debt, with the creditor often getting a corresponding tax deduction in any case.

6. Two exceptions where there is no debt remission income are:

   (a) When a person or a trust is a debtor and the creditor is a natural person who forgives the debt because of natural love and affection for the person or for the beneficiaries of the trust, or the trust was established to benefit a charity, the debt is deemed to be repaid by the debtor when it is forgiven: s. EW 44; and

   (b) When the debtor and creditor are both companies in the same consolidated group and they were both consolidated group companies for the whole term of the arrangement, the remission income under the BPA is excluded income: s. FM 8 and CX 60.

7. Other situations in which income could arise as a result of debt remission are as follows:

   (a) A company is regarded as providing money's worth to a person that is a transfer of value which could be a dividend if the person is released from an obligation to pay money to the company, either by agreement or by operation of law: s. CD 5(2);

   (b) The exemption for dividends paid and received within a New Zealand wholly owned group does not apply if the dividend is the release of an obligation to repay an amount lent treated as a dividend under s. CD 5(2): s. CW 10(5);

   (c) When amalgamating companies are parties to a financial arrangement that exists on the date of the amalgamation, the financial arrangement is deemed to have been discharged immediately before the amalgamation, with the consideration being the market value if the debtor is insolvent and unlikely to meet its obligations under the financial arrangement: s. FO 18(2);

   (d) When a debt owed by a company to its shareholder is capitalised in circumstances where there is no change to the shareholder's interest in the company and there is no actual or economic cost to the company, the general anti-avoidance provision potentially applies according to QB 15/01, which is considered further below.

QB 15/01: tax avoidance and debt capitalisation

8. The question is whether the general anti-avoidance provision, s. BG 1, will apply if a natural person shareholder:

   (a) Who holds all the $100 of shares in a qualifying company, "Company D"; and

   (b) Who has lent Company D $700;

   (c) Subscribes for additional capital in company D of $500, which is used to offset $500 of the debt owed to the shareholder, and Company D uses $200 of its own funds to repay the remainder of the debt, so that it would have no income arising from debt remission.

9. The conclusion is that s. BG 1 would potentially apply to this arrangement, and the supporting analysis is as follows:

   (a) While the financial arrangements rules are concerned with overall economic effects of a transaction, in the Commissioner's view, this requires looking at each of the parties involved in isolation: aside from the company consolidation and amalgamation rules, there is no indication Parliament contemplated that the parties should be considered from the perspective of a single economic unit when it comes to the BPA;

   (b) Where a financial arrangement is not repaid in full, there would ordinarily be income arising under the BPA as a result of the debt remission;

   (c) As a qualifying company, if Company D is unable to pay the tax on this income, the shareholder would be liable for the tax (although apparently nothing turns on Company D being a qualifying company);

   (d) A feature that Parliament would have expected to see when a financial arrangement ends is that the borrower has borne the economic cost of repaying the loan and the lender has received an economic benefit and, when this does not occur, income will arise for a borrower reflecting that the borrower has made an economic gain;

   (e) A s. BG 1 enquiry is not limited to the legal form of the arrangement: the whole of the arrangement is examined to establish its commercial and economic reality;

   (f) In this scenario there is no actual or economic cost to Company D in issuing shares to the existing shareholder and there is no change to the shareholder's interest in the company and no economic benefit to the shareholder;

   (g) The shareholder effectively refinances the repayment of $500 of the loan and there is an element of artificiality and contrivance in this aspect of the arrangement;

   (h) When Company D's situation is looked at in isolation, the shareholder has, in reality, remitted the loan, and the Commissioner considers that the economic reality of the arrangement would be the same even if the shareholder had subscribed cash that had been used by Company D to repay the loan;

   (i) In the Commissioner's view the arrangement is outside Parliament's purpose for the financial arrangements rules as it circumvents remission income arising under the BPA, and the arrangement has tax avoidance as its purpose or effect;

   (j) The comments of McGechan J in *AMP Life Ltd v CIR* (2000) 19 NZTC 15,940 (HC), that debt capitalisation on its own would not be a tax avoidance arrangement, are distinguished because they do "not necessarily reflect a considered judicial view on the issue of debt capitalisation in the context of tax avoidance" and the comments pre-date the Parliamentary contemplation test set out by the Supreme Court in *Ben Nevis Forestry Ventures v CIR* [2008] NZSC 115;

   (k) The tax avoidance purpose or effect in this case is unlikely to be merely incidental to another purpose or effect of the arrangement, and the particular arrangement cannot be explained away using a general purpose such as elimination of the shareholder loan or alleviation of Company D's insolvency (although in a particular case, such as where a regulatory body imposes an approach to the restoration of a subsidiary's insolvency, it may

be possible for a debt capitalisation arrangement to be merely incidental to some non-tax avoidance purpose or effect);

(l) Section BG 1 will apply to the remission income for Company D, and the shareholder will not get a corresponding tax deduction under the bad debt rules in s. DB 31 because the parties are associated.

10. An alternative scenario is briefly considered, where the company is solvent and is capitalised by the issue of shares to a third party. In this case, there is an economic effect because the existing shareholders suffer a dilution of their investment and the third party gains an equity interest in the company. This situation is more likely to have been contemplated by Parliament as on where no remission income arises under the BPA (although this would need to be considered on a case-by-case basis).

11. This situation is distinguished from an equivalent issue of shares to a third party lender by an insolvent company. While it is conceded that in some situations, depending on the facts, shares in an insolvent company may have some value to a third party lender, in most situations shares in an insolvent company will not have any real value to a third party lender and so will not constitute repayment of a loan in a real sense.

The position of the creditor when there is debt remission

12. The position of the creditor is briefly discussed in the Issues Paper. The bad debt deductions rules are contained in s. DB 31:

(a) A creditor is allowed a deduction for income from a financial arrangement that has been written off as a bad debt in the income year: s. DB 31(2) – this includes the situation where the debtor and creditor are associated persons;

(b) A creditor who is in the business of holding or dealing in financial arrangements that are the same as, or similar to, as the financial arrangement that has been written off as a bad debt is allowed a deduction, under s. DB 31(3), for the unpaid principal amount, providing that:

(i) The creditor is not associated with the debtor: s. DB 31(3)(c) – it is noted in the Issues Paper that "the reason for the associated party bad debt prohibition is that allowing a deduction for a bad debt would bias investment towards debt, as by definition all gains will be attributed to the equity investment only, whereas losses can be attributed over both investments"; and

(ii) In the case of a debt acquired for less than its face value, the deduction is limited to the consideration paid for acquiring the debt: s. DB 31(4B); and

(iii) In the case of a debt that a limited recourse arrangement relates to, the deduction is limited to the extent to which the amount of the debt exceeds the consideration paid to the creditor under the limited recourse arrangement: s. DB 31(4C) (providing that, when the BPA is performed for the limited recourse arrangement, the income that results if the consideration received under the limited recourse arrangement exceeds the amount paid is offset by a corresponding deduction: s. DB 31(4D)).

13. If the creditor is a company and debtor is also a company that uses the funds to finance deductions that have given rise to a tax loss for itself or another company, the deduction for a bad debt is limited to the extent to which it exceeds any tax loss offset between the creditor company or another company in the same group involving the tax loss that arose from the use of the debt: s. DB 31(5).

Arun David, Director,
DavidCo Limited