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WEEKLY COMMENT: FRIDAY 10 NOVEMBER 2017

1. The *Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017* ("the Closely Held Companies Act") received the Royal assent on 30 March 2017. There are a number of changes affecting various parts of the Income Tax Act 2007 and the Goods and Services tax Act 1985.

2. This week and next week I look at the amendments to the related parties debt remission rules.

Introduction

3. When a loan to an associated person was forgiven there was an asymmetric tax outcome because the creditor was denied a bad debt deduction for the principal of the loan, but the debtor was treated as having income of the amount remitted or forgiven.

4. To briefly recap, the financial arrangements rules require a wash up "base price adjustment" ("BPA") calculation, in s. EW 31, to be performed when a debt is terminated. A debtor is taxed on a positive "consideration" (i.e. debt remission income) if the amount paid to the debtor exceeds the amount paid by the debtor (for example, because the debt has been forgiven).

5. For a creditor, a negative "consideration" (due to the amount repaid by the debtor being less than the amount advanced to the debtor) is offset by the inclusion of any "amount remitted" as an additional deemed repayment. Therefore, the creditor does not get a deduction corresponding to the debtor's debt remission income.

6. A commonly used avoidance technique was to capitalise the debt. Inland Revenue concluded, in "QB 15/01: Income tax – Tax avoidance and debt capitalisation" published in *Tax Information Bulletin* Vol. 27, No. 3, April 2015, that debt capitalisation, in the circumstances described in QB 15/01 where the debtor is unable to repay the debt, is tax avoidance.

7. The aim of the new rules is that debt remission income will not arise in circumstances where the debt remission causes no change in the net wealth of the economic group or dilution of ownership. Instead, the debt will be regarded as being fully repaid.

8. The rules are carefully targeted at debt remission situations where there would be no real change in ownership (increase in wealth). The amendments apply to debtors who are companies, look-through companies and partnerships. Additional technical amendments are designed to ensure that the bad debt and debt guarantee rules work as intended within the economic group context.

The core debt remission rules

9. The new debt remission rules are set out in s. EW 46C and apply retrospectively for the 2008-09 and later income years.

10. Section EW 46C(4) and s. EW 46C(5) state the basic rules that forgiven debts are deemed to have been paid in specified circumstances (so that no debt forgiveness income will arise).

11. The effect of the amendments is that the amount forgiven will form part of "consideration" in the base price adjustment ("BPA") formula in s. EW 31, for both the debtor and the creditor. Therefore, there will be no "amount remitted" for the creditor and there will be no net income for the debtor.

12. There are separate rules that apply for:

    (a) Wholly-owned group companies; and

    (b) Other ownership and debt structures – i.e. debt owed to owners by other companies, partnerships (including limited partnerships) and look-through companies.

13. For wholly-owned group companies, the amount of the debt forgiven is treated as consideration paid by the debtor on the date on which the creditor forgives it, and it is also regarded as consideration received by the creditor on that date, if the relevant debt, creditor, and debtor are as set out in s. EW 46C(1)(a) and (b), as follows:

    (a) The debtor is a New Zealand resident company and the creditor is a member of the same wholly-owned group of companies as the debtor; or

    (b) If the debtor is a company that is not resident in New Zealand (i.e. a controlled foreign company or "CFC"), the creditor is a member of the same wholly-owned group of companies as the debtor and the debtor is directly wholly owned (by reference to voting interests or voting and market value interests, as appropriate) by a group of New Zealand resident companies, (i.e. before looking through the NZ companies under the look-through rule for corporate shareholders in s. YC 4).

14. In other circumstances referred to in s. EW 46C(1)(c), (d) and (e), the debtor is treated as having paid the amount of debt on the date on which the creditor forgives it and the creditor is treated as having been paid the amount of debt on the date on which the creditor forgives it, if the "proportional debt ratio" for the amount equals the "proportional ownership ratio".

15. It is stated on page 107 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 ("the TIB Item") that the rule in s. EW 46C(1)(a), which applies to wholly-owned group companies when the debtor is a New Zealand resident, "conceptually has limited relevance … but practically provides a simple rule for most wholly-owned group companies … (and) is relevant when the debtor is the top tier New Zealand company and the creditor is part of the New Zealand resident group of companies".

16. It is noted on page 107 of the TIB Item that the more general rule is the rule in s. EW 46C(1)(b), which applies to wholly-owned group companies where:

    (a) The debtor is not the top tier New Zealand company; or

(b) All of the ownership interests are held by New Zealand resident companies (before looking through them to underlying shareholders), which would include both resident group members other than the top tier company and CFCs that are wholly-owned by New Zealand resident group companies.

17. It is also noted on page 107 of the TIB Item that the point about the residence of the debtor is to ensure that there is no debt remission where a non-resident shareholder benefits. The present dividend rules should continue to apply in this situation. (For the purposes of the dividend rules, s. CD 5(2) stated that a company provides money's worth to a person if the person is released from an obligation to pay money to the company, either by agreement or by operation of law. However, as discussed next week, an amendment to this rule means that it does not apply to situations covered by the new wholly-owned group debt remission rules.)

18. Section EW 46C(3) contains an exception to the rule for debtors and creditors that belong to the same to the wholly-owned group of companies. The deemed repayment rules in ss. EW 46C(4) and (5) will not apply if:

    (a) The creditor is a non-resident; and

    (b) A person that is not a member of the wholly-owned group of companies has previously held the debt.

19. It is noted on page 108 of the TIB Item that this exception is to prevent "debt parking" when the creditor is not in the New Zealand tax base.

20. Another important point with the wholly-owned group debt remission rules is that they do not extent to FIFs (i.e. shareholdings in foreign companies that are not CFCs), where one is wholly-owned by the other but they are not wholly-owned by the New Zealand FIF owners. It is stated on page 107 of the TIB Item that consideration will be given to addressing this as a remedial in a future tax bill.

21. The "other circumstances" specified in s. EW 46C(1)(c), (d) and (e) are as follows:

    (a) Section EW 46C(1)(c) refers to a debtor that is a company, where the creditor is not a member of the same wholly-owned group of companies as the debtor, but the creditor does have ownership interests or, as applicable, market value interests in the debtor;

    (b) Section EW 46C(1)(d) refers to a debtor that is a partnership, where the creditor has a partner's interest in the income of the debtor; and

    (c) Section EW 46C(1)(e) refers to a debtor that is a look-through company, where the creditor has an effective look-through interest in the debtor.

22. In these "other circumstances", the "proportional debt ratio" for the amount of the debt forgiven must equal the proportional ownership ratio. These terms are defined in s. EW 46C(6) as follows:

    (a) "Proportional debt ratio" means, for a creditor and an amount of debt, the percentage that the creditor's amount bears to the total amounts of debt to which s. EW 46C applies forgiven at the time the creditor's debt is forgiven; and

    (b) "Proportional ownership ratio" means:

(i) In the case of a debtor company, the creditor's percentage of the ownership (or market value) interests in the debtor company, ignoring "nominal shares";

(ii) In the case of a debtor partnership, the creditor's total partner's interests in the partnership;

(iii) In the case of a look-through company, the creditor's total effective look-through interests in the company, ignoring "nominal shares".

23. For the purpose of determining the "proportional ownership ratio":

(a) "Nominal shares" are defined in s. EW 46C(6) as shares representing voting (or, as applicable, market value interests) of no more than 3%, held by the trustee of a share purchase scheme, or employees or former employees of the debtor;

(b) In the case of a debtor company (which is not in the same wholly-owned group as the creditor(s)), s. EW 46C(2)(c) states that creditor companies, or companies with interests in the debtor company, that are in the same wholly-owned group of companies, may be treated as a single corporate creditor;

(c) A group of natural persons who are creditors or who have interests in the debtor are treated as one creditor holding the total debts and interests of the group, if each person has natural love and affection for the others; a trust may join the single creditor group if:

(i) The trust was established mainly to benefit a natural person for whom each person of the single creditor group has natural love and affection; and

(ii) The amount given by dividing the amount that the trust forgives the debtor by the trust's proportional ownership ratio is less than the amount given by dividing the amount that the single creditor group forgives the debtor by the group's proportional ownership ratio (*for example*: $100 forgiven by the trust ÷ 40% ownership is greater than $100 forgiven by the group ÷ 50% ownership, so the trust may not join the group, even if the required natural love and affection exists).

24. The application of the debt remission rule to trusts is limited by the above rule to circumstances where the trust is not remitting more debt that its share according to its ownership interests.

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