Related parties debt remission

An officials' issues paper

February 2015

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First published in February 2015 by Policy and Strategy, Inland Revenue, PO Box 2198, Wellington, 6140.

Related parties debt remission – an officials' issues paper.
ISBN 978-0-478-42405-8

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CHAPTER 1

Background

1.1 Debt remission is the extinguishing of a debtor's liability by operation of law or forgiveness by the creditor.

1.2 This issues paper discusses proposed changes to the tax consequences of certain related parties debt remission when the debtor (the borrower) and the creditor (the lender) are either group companies, or when an owner or owners of a company or a partnership remit debt. These people or entities are referred to in this paper as "related parties".

1.3 In particular, this paper considers debt remission in situations when there is no change of ownership of the debtor, or the net wealth of the "owner". A debt remission within a wholly owned group of companies is a very common example of this. The company that advanced the loan (the creditor) suffers a loss, while the other company that borrowed the money (the debtor) has a corresponding gain but overall, there is no change in ownership of the companies, or in the owners' wealth.

1.4 Under present tax law, debt remission in these circumstances produces taxable income to the debtor, but usually no tax deduction is available to the creditor. Until recently, this asymmetric tax outcome was commonly avoided by the debtor issuing equity to the creditor to "satisfy" the debt obligation.

1.5 However, an interpretation by Inland Revenue has indicated that these debt capitalisations may sometimes be considered to be tax avoidance and if so they are taxed as a debt remission. (See the Appendix.)

1.6 As well as the group company scenario, other relevant scenarios seemingly subject to the debt remission rules (either directly or potentially via the anti-avoidance analysis and reconstruction) include:

- debt remission between an overseas parent and its wholly owned New Zealand subsidiary; and

- shareholder or partner debt advanced to a company or partnership (which term includes look-through companies and limited partnerships), where the debt is remitted pro-rata to ownership.

Policy proposals

1.7 The Government has agreed, subject to confirmation following this consultation, to the following core proposal:

there should be no debt remission income for the debtor when the debtor and the creditor are in the New Zealand tax base, including controlled foreign company (CFC) debtors; and

- they are members of the same wholly owned group of companies;

or

- the debtor is a company or partnership; and
  - all of the relevant debt remitted is owed to shareholders or partners in the debtor; and
  - if we presume that if the debt remitted was instead capitalised, there would be no dilution of ownership of the debtor following the remission and all owners' proportionate ownership in the debtor is unchanged.

1.8 Again, subject to confirmation after consultation, the Government has agreed that the core proposal apply from the commencement of the 2006–07 tax year.

Inland Revenue's operational approach

1.9 Given the decision made by the Government, Inland Revenue will not, pending the outcome of the policy process, be devoting resources to determine whether there is any debt remission income arising in the situations described at paragraph 1.7.

Outstanding policy issue – inbound investment

1.10 When the owner/creditor is a non-resident, the use of related-party inbound debt is a key BEPS (base erosion and profit shifting) concern. Continuing to tax debt remission in this case may dissuade non-residents from over-gearing to begin with. On the other hand, leaving the present tax outcomes in place could also dissuade non-residents from reducing gearing levels.

1.11 Officials' current conclusion for inbound investment is that more work is needed, and this work is ongoing. However, submissions on this are welcome.

Technical matters

1.12 A number of second-tier technical issues have also been identified. These are discussed in this paper.

1.13 We believe that the core proposal has no fiscal effect as debt remission income in the past did not arise because taxpayers used debt capitalisation instead.

Submissions

1.14 Submissions on this paper should be made by 14 April 2015 and can be addressed to:

Debt remission
C/- Deputy Commissioner
Policy and Strategy
Inland Revenue Department
P O Box 2198
Wellington 6140

Or email: policy.webmaster@ird.govt.nz with "Debt remission" in the subject line.

1.15 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

Current tax policy and law

2.1 Debt can be remitted when the debtor:

- is discharged from making remaining payments;
- is insolvent or liquidated;
- enters into a deed of composition with its creditors that results in full remission; or
- has no obligation to make payments when, because of the passage of time, the debt is irrecoverable or unenforceable.

2.2 Section EW 29 of the Income Tax Act 2007 provides that these remissions (and some other scenarios) can trigger a section EW 31 base price adjustment (BPA).[1]

2.3 Under Inland Revenue's Office of the Chief Tax Counsel's anti-avoidance analysis (see the Appendix), debt can also be deemed to be remitted when there is a debt capitalisation. This is further discussed below.

The debtor

2.4 Under the financial arrangement rules, a remission of debt owing results in income to the debtor. As stated in the December 1997 discussion document, *Taxation of Financial Arrangements,* at paragraph 11.3:

> The purpose of the debt remission rules is to recognise the fact that the forgiveness of a debt increases the wealth of the debtor. This should, as with all other gains under a financial arrangement, be brought to tax.

2.5 This outcome was considered and reaffirmed as part of the deliberations on the changes to be made as a result of the discussion document and has applied since the enactment of the financial arrangements rules in 1986.

2.6 The section EW 31 BPA produces this remission income as intended.

2.7 This debt remission income is the correct policy outcome when the debt is from a third party, and this is generally accepted by the private sector. Example 1 illustrates the correct outcome of a debt remission.

[1] Unless otherwise stated all section references are to the Income Tax Act 2007.

Example 1

Bank has advanced two loans to Jo Ltd. Jo Ltd has significant liquidity problems and, as part of the reconstruction of Jo Ltd, Bank remits one of the loans. Under the BPA, Jo Ltd has financial arrangement income of the amount of the loan remitted.

Liquidation or insolvency

2.8 The effect of liquidation or insolvency is that debt remission income is not effectively brought to account for taxation purposes. For companies, the remission income is deemed to arise at the conclusion of the liquidation process. At this stage, the company has ceased to exist by way of being struck off and there is nothing left to pay the tax. Similar analysis applies for insolvency. Refer Example 2.

Example 2

Bank has advanced a loan to Joe Ltd. Joe Ltd has significant problems and is liquidated. Thus the loan is remitted. Under the BPA, Joe Ltd theoretically has financial arrangement income of the amount of the loan remitted. However, in practice, because the remission is deemed to happen immediately after the liquidation is finished, there are no assets left with which to pay any resulting taxation liability.

2.9 This was contrary to the initial policy intent.[2] An attempt was made to address this in the 1997 discussion document.[3] However, after submissions were considered, it was decided not to proceed because it would dilute the recovery of the general pool of creditors as any resultant tax liability would rank alongside these creditors, rather than after them.

Debt parking

2.10 Debt parking rules were introduced as a result of the discussion document. Before this it was not uncommon for an associated person of the debtor to buy distressed debt from the creditor and effectively freeze the arrangement in order to defer or prevent BPA income of the debtor while often providing a bad debt deduction for the original creditor.[4] Example 3 is an illustration of this.

[2] Oliver and Glazebrook, pp 109, 110.
[3] See paragraphs 11.22 – 22.26.
[4] See paragraphs 11.19 – 11.33.

Example 3

Bank has advanced a loan to Bill Ltd. Bill Ltd develops significant liquidity problems and, as part of the restructuring of Bill Ltd, the owner of Bill Ltd buys the loan from the bank for 40 percent of its face value. This forces a BPA, and Bill Ltd has financial arrangement income of 60 percent of the loan, being the amount effectively remitted.

Exceptions to the debt remission rule

2.11 There are two legislative exceptions to the general debt remission rule. First, debt forgiven for natural love and affection is deemed to have been fully repaid for BPA purposes. This is typically a family situation and is not within scope of this reform.

2.12 Secondly, when in relation to a financial arrangement, both parties were members of the same consolidated group at all times during the life of the financial arrangement, any remission income under the debtor's BPA is not taxable.[5]

Certain dividends

2.13 Debt remission income derived by a shareholder debtor from a company, even if the shareholder is a member of the same wholly owned group of companies, is taxable as a dividend under sections CD 5(2) and CW 10(4).

2.14 This law is still current, except for a debt remission that qualifies for the exemption provided by the consolidated group debt remission exemption.[6] See Example 4.

Example 4

Sub Ltd is wholly owned by Parent Co Ltd. Sub Ltd lends $1 million to Parent Co Ltd and, two years later, remits the debt. Parent Co Ltd is deemed to have derived a taxable dividend equal to the amount remitted. This is because the dividend is explicitly excluded from the wholly owned group inter-corporate dividend exemption.

[5] Section FM 8(3).
[6] Sections CX 60 and FM 8(3).

Amalgamations

2.15 The amalgamation rules provide that when amalgamating companies are parties to a financial arrangement, the debtor's solvency must be taken into account.[7] If the debtor is insolvent, and unlikely to repay the loan, a BPA immediately before the amalgamation is required. Under current policy settings this should produce remission income.

OCTC view of the avoidance tax law

2.16 Inland Revenue's Office of the Chief Tax Council's (OCTC) finding is that the capitalisation of debt into shares is prima facie tax avoidance in situations when there is no effective change in ownership of the debtor (regardless of whether the debtor is solvent or insolvent).

2.17 Unless this avoidance is found to be merely incidental, the amount of debt capitalised is reconstructed as debt remission income of the debtor. See Example 5.

Example 5

This is simplified from the example in the QWBA on debt capitalisation. The 100 percent Shareholder has made a $500 loan to Company D. Later, Company D issues $500 more shares to Shareholder and uses the receipt to repay the loan from Shareholder. In the particular circumstances this was found to be tax avoidance and it is reconstructed as the remittance of the $500 loan so Company D derives BPA income of $500.

2.18 Given the current Inland Revenue view that there is only partial transparency between partners and their partnership or limited partnership, and between shareholders and their look-through company, this OCTC finding potentially has very wide application. See Example 6.

Example 6

Raewyn and Paul, equal partners in the R & P Partnership, have each advanced $500 to the partnership. In the circumstances, this is treated as a financial arrangement. Later, the R & P Partnership is not trading well and Raewyn and Paul decide to capitalise the debt. Unless the debt remission outcome is merely incidental, the R & P Partnership will derive BPA income of $1,000.

[7] Section FO 18.

2.19 Related parties debt capitalisation has been a very common debt management technique in New Zealand. There are a number of reasons why related parties debt might be capitalised, including:

- group reorganisation immediately before the sale of a subsidiary;
- reducing a subsidiary's debt level to a more appropriate level, which may be influenced by thin capitalisation issues if the subsidiary is foreign owned;
- supporting a technically insolvent company when the alternative is to liquidate or strike off the company – frequently in this case the parent company has paid off the third-party creditors and often this is what has caused or exacerbated the associated persons debt;
- supporting a partnership that has liquidity issues; and
- supporting a technically insolvent subsidiary that has to be retained for a period, perhaps because it has given vendor warrantees.

2.20 Anecdotally, when the OCTC avoidance analysis of intra-group debt capitalisations began emerging in about November 2013, intra-group debt capitalisations dropped off rapidly. Currently, insolvent subsidiaries are either liquidated, or, more usually, retained in their insolvent state. Both of these outcomes can have their problems and, in the long term, these approaches do not provide a sustainable solution.

The creditor

2.21 When the parties are not associated (using the usual test), the bad debt deduction for the principal depends on what basis the creditor holds the debt.

2.22 If the creditor is in the business of holding or dealing in such debt, the creditor generally obtains a deduction for a bad debt under the bad debt rules.

2.23 If the creditor in not in such a business, they do not get a deduction for the "capital account" loss resulting from the bad debt. Frequently, debt of the sort that is under discussion in this paper will be on "capital account". Example 7 illustrates this.

Example 7

Joe has advanced a loan to his company Joe Ltd. Joe Ltd later has significant liquidity problems. Joe decides to write off the outstanding balance as a bad debt. As Joe is not in the business of holding or dealing in such debt he is not entitled to a bad debt deduction.

Alternatively, if Bank had advanced the loan it would be entitled to a bad debt deduction as it would be in the business of holding or dealing in such debt.

Associated persons bad debt override

2.24 The business test described above is overridden when the parties are associated. The associated person creditor is explicitly denied a bad debt deduction for the principal of a debt (see section DB 31(3)(c)). Thus, for example, in an intra-group situation, there is no prospect of the creditor obtaining a tax deduction for the principal of a debt.

2.25 The associated persons rule has been in place in one form or another since the financial arrangements rules were introduced in 1986. A shareholder has a choice of investing in a company or partnership by way of debt or equity. Except for situations when the creditor is non-resident or is otherwise outside the tax base, the investors' debt and equity investment is economically substitutable. 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.[8] See Example 8.

Example 8

Using the Example 7 facts, even if Joe was in the business of holding or dealing in these loans, he would still be denied a deduction because of the associated persons override.

2.26 However, associated persons creditors are currently allowed bad debt deductions for "interest" accrued as income that is "bad".

Asymmetric result

2.27 The fundamental point under consideration in this paper is the asymmetric tax result that can arise from related parties debt remission – the creditor is denied a tax deduction, but the debtor, from the same transaction, has taxable income. This is illustrated in Example 9.

[8] "*The Supplementary Report of the Consultative Committee on Accrual Tax Treatment of Income and Expenditure*", paragraph 13.247.

Example 9

Jill has advanced a $500 loan to her wholly owned company, Jill Ltd, which has made a look-through company election. This loan is treated as a financial arrangement. Later, Jill Ltd has financial difficulties and the loan is remitted.

Because of the look-through company election, Jill derives $500 loan remission income from Jill Ltd's BPA.

However, Jill is denied a bad debt deduction because she is an associated person.

Thus Jill has look-through company attributed BPA income of $500, and no deduction against this. This is the asymmetric result.

CHAPTER 3

Core policy analysis

3.1 When the separate positions of the debtor and the creditor are considered in isolation from each other, it is understandable that we have ended up with the present associated persons asymmetric tax result.

3.2 Alternative suggestions to this debt remission rule were discussed by the Valabh Committee which suggested, among other things:[9]

> [to] retain restrictions on [associated persons] bad debts deductibility but remove the inclusion of debt remission income in assessable income.

3.3 No legislative change resulted from this.

3.4 The 1977 discussion document canvassed aspects of debt remission, including associated persons debt remission, but again no legislative changes resulted.

3.5 Alan Judge's 1997 paper, *The accrual rules*, prepared for the (then) Institute of Chartered Accountants of New Zealand (now known as Chartered Accountants Australia and New Zealand) tax conference that year contains the most comprehensive discussion of debt remission and debt capitalisation and potential avoidance concerns on pages 31–51. The points he made in both the context of associated persons debt remission and more generally include: "The varying treatment of debt remission and extinguishment in different circumstances is unsatisfactory".

3.6 It seems fair to conclude that policy analysis of the combined result in related party debt remission has not been fully considered until now. Presumably this is because until recently, related party debt capitalisation was understood to be acceptable.

Economic consequence of certain related parties debt remission

3.7 Economically, it does not matter how related party debt is remitted – either by direct remission or indirectly via debt capitalisation. As long as the remission or capitalisation is pro rata by owners, or within a wholly owned group of companies, the outcome is the same – there is no net change in the owners' wealth.

3.8 The best example of this is a wholly owned group of companies, where economically, the consolidated result or wealth of the owners of the group does not change because of a debt remission or debt capitalisation within the group.

[9] *Operational aspects of the accruals regime*,: discussion paper, October 1991, pp 27–38.

Debt capitalisation inside a wholly owned group

3.9 Within a wholly owned group of companies, the financial reporting consolidated profit and loss and balance sheet result is the same at NIL. This consolidated financial reporting result directly reflects the economic result of the group as a whole, which is that the net worth or wealth of the group does not change as a result of debt remission where the debt has always been inside the group. See Example 10.

Example 10

Parent Ltd advanced wholly owned Sub Ltd a loan of $500. Sub Ltd's trading was poor and Parent Ltd had to advance a further loan of $400 so Sub Ltd could pay off its third-party creditors. Sub Ltd now has shareholder funds of negative $900.

At this stage Parent Ltd has lost $900 (plus any equity investment in Sub Ltd).

Sub Ltd then capitalises the Parent Ltd loan of $900 into more shares. This capitalisation does not change the net wealth of Sub Ltd and Parent Ltd. Parent Ltd and Sub Ltd's intra-company entries effectively cancel each other upon consolidation.

3.10 Further, if the parties are in the New Zealand tax base, debt and equity are generally economically substitutable.[10] This is certainly the case within a group of companies when viewed from the perspective of the group.

3.11 Within a wholly owned group there is a range of concessions and adjustments for intra-group transactions. Within a consolidated group there are even more. In general, these concessions and adjustments reflect the economic reality that the group (or consolidated group) is one economic unit.

3.12 Examples of these can be illustrated:

Intra-group transaction	Wholly owned group	Consolidated group
Dividends	Generally exempt	Exempt
Trading stock, livestock and excepted financial arrangements	Intra-group profit not taxed	Intra-group profit not taxed
Other revenue account property	No special rules – intra-group profit taxed	Intra-group profit not taxed
Financial arrangements	Generally symmetric under ordinary rules, but no special treatment except for bad debt deduction prohibition	Symmetric
Depreciable property	No cost base uplift, but depreciation recovered/loss on sale are accounted for	Transfer at TBV (cost and accumulated depreciation transfer)

[10] The imputation regime generally produces this result.

3.13 Some of these results seem to be historical anomalies (for example, "other revenue account property"); others are more deliberate ("financial arrangements", for example). However, given the general use of the consolidation regime, and the fact that it has never been seriously reviewed, there is no reason not to address apparent inconsistences, such as the rules around intra-group debt remission.

3.14 There also seems to be a public benefit argument – as previously noted, intra-group debt is often advanced to enable an otherwise insolvent subsidiary to pay off its third-party creditors – why should the tax system then penalise any subsequent rationalisation by way of debt remission or capitalisation?

3.15 Another policy question that has been asked is why should the timing of the equity contribution matter? It is not tax avoidance if it is put in at Day 1, but if put in later, it may be tax avoidance.

3.16 When an insolvent subsidiary is liquidated, under current practice the tax policy outcome is that no extra tax is payable – the policy question then arises over why the Income Tax Act should have a bias towards liquidation as an alternative to debt remission or capitalisation.

3.17 We conclude that the asymmetric debt remission tax result should not generally apply in the intra-wholly owned group situation when all companies involved are resident in New Zealand. This is because there is no change in the wealth of the group, and therefore no economic transaction to tax. The proposed outcome is illustrated in Example 11.

Example 11

Parent Ltd advanced wholly owned Sub Ltd $500. Sub Ltd's trading was poor and Parent Ltd had to advance a further $400 so Sub Ltd could pay off its third-party creditors. Sub Ltd now has shareholder funds of negative $900.

At this stage Parent Ltd has lost $900 (plus any equity investment in Sub Ltd).

Sub Ltd then capitalises the Parent Ltd advance for $900 more shares. Under current tax law, and presuming that the avoidance was not incidental, Sub Ltd would have $900 debt remission income, which would also be the group result as Parent Ltd does not get a bad debt deduction.

The proposal put forward in this issues paper is to make the tax outcome symmetric.

Other related party debt remission

3.18 Under the OCTC analysis, a key issue on whether debt capitalisation may be reconstructed as debt remission is that the capitalisation does not result in any proportionate change in ownership. From a tax policy perspective, this extends to owners' debt remission when the remission is pro rata around all owners. Thus other scenarios should be part of the discussion – for example:

- a corporate debtor with a non-corporate New Zealand shareholder (individual or trust) who wholly owns his/her/its company and remits debt owing by the company to them;[11]
- a corporate debtor with pro rata debt and equity held by New Zealand shareholders when the debt is remitted (or capitalised) pro rata;
- a pro rata debt advanced by shareholders or partners when the debt is then remitted (or capitalised) pro rata; and
- a non-resident corporate shareholder who wholly owns a New Zealand company (or group) when the debt is remitted (or capitalised).

3.19 Other scenarios exist (for example, a non-resident non-corporate with a wholly owned New Zealand company), but analysis of the four scenarios above should provide sufficient information to apply universally.

The corporate debtor, non-corporate single New Zealand shareholder scenario

3.20 In this scenario, the shareholder could be an individual or a trust. From the perspective of the shareholder, the shareholder's economic wealth does not change because they have remitted debt owed to the shareholder by his/hers/its wholly owned company.

3.21 The analysis is similar to the wholly owned group debt capitalisation discussion immediately above, and the policy outcome follows as well – debt remission by the shareholder should not cause debt remission income in these circumstances. Example 12 illustrates this point.

Example 12

John has advanced a $500 loan to his wholly owned company, John Ltd. This loan is treated as a financial arrangement. Later, John Ltd has financial difficulties and the loan is remitted.

John Ltd derives $500 loan remission income from the BPA. However, John is denied a bad debt deduction because he is an associated person.

The proposal in this issues paper is to make the tax outcome symmetric.

[11] Effectively scenario 4 of the draft QWBA avoidance scenarios.

3.22 However, care will have to be taken to ensure that any debt forgiveness by the company to a non-corporate shareholder is taxed, as it is, economically, a dividend.

Pro rata debt capitalisation when the debtor is a corporate

3.23 In this scenario, the company could be a corporate joint venture (JV) or similar, the shareholder debt is pro rata to ownership, is all held by New Zealand-resident shareholders, and the subsequent debt remission (either directly or via debt capitalisation) is also pro rata.

3.24 Again, economically, nothing has happened because from the owners' perspective, all they have done is remit some debt, or swapped some debt for equity. The owners' "consolidated" wealth has not changed from what it was before the debt remission or capitalisation. Again, the tax result should not be asymmetric, as shown in Example 13.

Example 13

Mike and Judy each own 50 percent of JV Ltd. They have also each advanced $500 to JV Ltd. JV Ltd trades unsuccessfully and Mike and Judy each remit the $500 debt owing to them by JV Ltd.

Under current tax law, JV Ltd would have $1,000 debt remission income, and Mike and Judy would be denied bad debt deductions.

The proposal is to make the tax outcome symmetric.

3.25 If a company remits debt owed by shareholders, this amounts to a return to owners – that is, the analysis works for owners' debt advanced to the company, but not vice versa. This remission is, economically, a dividend.

Partners' advances to partnerships

3.26 The term "partnership" in this paper includes look-through companies and limited partnerships.

3.27 This scenario presumes that an advance by a partner to a partnership can be a financial arrangement because the partner can have different capacities – one as an owner, and one as a lender of monies.

3.28 If the debt is a financial arrangement, similar debt remission issues are relevant – that is, when the debt is remitted or capitalised pro rata to the ownership of the partnership, there is (or for capitalisation, can be) an asymmetric debt remission income. Again, from a policy perspective, this tax result should not be asymmetric. See Example 14.

Example 14

Raewyn and Paul, equal partners in the R & P Partnership, have each advanced $500 to the partnership. In the circumstances, this is treated as a financial arrangement. Later, because the R & P Partnership is not trading well, Raewyn and Paul decide to capitalise the debt.

Under current tax law, unless the debt remission outcome is merely incidental, the R & P Partnership will derive BPA income of $1,000 but Raewyn and Paul do not get a corresponding tax deduction, even although their net wealth is unchanged.

The proposal is to make the tax outcome symmetric.

3.29 There is an associated question to this scenario. When partnership debt is not remitted pro rata by partners, there is a genuine transfer of wealth among the partners and debt remission outcomes apply. However, the question arises whether a partner-creditor that remits partnership debt (a non-deductible loss) should suffer their share of the associated remission income. This issue will be considered as part of a separate project.

Outbound investment into a wholly owned CFC

3.30 Remission of debt owed by a controlled foreign company (CFC) may result in an "active" CFC becoming "passive" from a tax perspective. If the CFC is passive, or becomes passive because of the remission, debt remission income will arise.

3.31 Conceptually, a CFC is inside the New Zealand tax base to the extent that it is owned by New Zealanders (ignoring FIF interests). However, the "active income exemption" effectively means its income is not actually subject to New Zealand taxation. This New Zealand tax-resident presumption can still reasonably be used so that when owners' debt is remitted or capitalised pro rata to the owners, no remission income should arise for taxation purposes.

3.32 Our analysis indicates that this would not present any unexpected or inappropriate taxation results.

The non-resident inbound investment scenario

3.33 Analysis of this scenario is complicated because the creditor is not in the New Zealand tax base. When the owner/creditor is a non-resident and the debtor is New Zealand-resident, the use of related persons inbound debt is a key BEPS (base erosion and profit shifting) concern.

3.34 From the perspective of the owner, the owner's economic wealth does not change because the owner has remitted debt owed to them by their wholly owned New Zealand subsidiary company. Also, the New Zealand tax base is no worse off, and may be better off, by not impeding the conversion of debt to equity because the obligation to pay (deductible) interest ranks higher than the obligation to pay dividends, and dividends are paid out after tax.

3.35 Alternatively, there is the question of whether this debt remission rule should buttress the current thin capitalisation boundary of 60 percent and therefore provide some base protection. If we allow debt remission/capitalisation in this context to be non-taxable, would that further encourage New Zealand subsidiaries of foreign companies to push the 60 percent debt/assets boundary by capitalising more debt when they are close to the boundary.

3.36 In this context, we have seen examples of debt capitalisation when a foreign-owned New Zealand company has been geared so that it has not been able to pay the interest owed. The interest has then been added to the company's debt and subsequently effectively capitalised into equity. Taxing these capitalisations may dissuade this type of excessive gearing.

3.37 However, we acknowledge that it is arguable that both the thin capitalisation and transfer pricing rules should stand alone, and that it may not be principled to use the related parties debt remission rules to buttress them.

3.38 Policy analysis is still underway on this issue, but submissions on matters that taxpayers believe are relevant to this scenario are welcome.

Proposed solution

3.39 There are two ways the related persons asymmetric result could be resolved:

- turning the debtor's remission income off; or
- allowing the creditor a deduction.

3.40 The first option seems more appropriate.

3.41 Inside a wholly owned group of companies the second option could cause problems if the debtor is liquidated as insolvent (with no taxation on the income). This would effectively allow a double deduction (the trading loss and the bad debt deduction) for a single economic loss – presuming that the liquidated company's tax losses have been transferred around the group.

3.42 We therefore recommend that the debtor's debt remission income is "turned off".

CHAPTER 4

Technical issues

Tax losses

4.1 In general, tax losses should not be affected by related party debt remission under this paper's core proposal. These losses presumably result from third-party trading and should be treated as being genuine for the purposes of this paper's proposals.

4.2 Losses arising from related party interest income and associated bad debt write-offs is an exception, and is dealt with below.

Accrued interest

4.3 The outcomes from these proposals should be, in the domestic context, symmetrical. If the related party creditor has taken a bad debt deduction for an "interest" accrual, the outcome may not be symmetrical.

4.4 Borders seem to complicate this analysis – this discussion presumes that all parties are New Zealand-resident.

4.5 New Zealand has no general or specific rules under which a creditor who takes a bad debt deduction has to notify the debtor. However, it might be reasonable to presume that an associated person debtor could be expected to have knowledge about any bad debt deduction for "interest" that the creditor takes. Example 15 provides a likely scenario.

Example 15

Parent Co has made a zero coupon loan to its wholly owned Sub Co. After a couple of years, the subsidiary is either insolvent, or very close to being insolvent.

Parent Co takes an annual bad debt deduction for its financial arrangement "interest" income. Sub Co continues to accrue its financial arrangement "interest" expense, which increases its overall tax losses and annually offsets these losses to another company in the group.

Economically, the group has two available deductions – the bad debt write off, and the "interest" deduction, facilitated by the group tax loss offset. Against this there is one strand of income – being the "interest" income of parent company/creditor.

4.6 The outcome described in Example 15 is available under present law and, anecdotally, is being used in some circumstances. Theoretically, the advantage is cancelled eventually when the BPA is done because the "interest" deduction of the subsidiary/debtor is reversed. Any reversal could be in the distant future as the timing of the BPA is controlled by the related parties. Further, if the debtor is eventually liquidated, the reversal will not be effective as no taxation will be paid.

4.7 Even if the advantage is merely timing, it is not a tenable policy outcome.

4.8 A possible policy solution would be to disallow a bad debt deduction for associated persons interest receivable. This is because the debtor will likely be taking a deduction for the accrual of interest. This would mean that the tax outcome is symmetric when the actual interest deduction is being used.

4.9 This symmetric outcome is important, as a net deduction could potentially be grouped and utilised within the wider group even if the debtor is not in a position to obtain any benefit from the deduction due to a net loss position. However, the disallowance of the creditor's bad debt deduction should not be dependent on this as it would be difficult to know whether the debtor would be able to utilise the deduction in a later year (by carrying the net loss forward) or by grouping the loss with the creditor or another company in a later year.

4.10 A significant advantage of this solution is that it can apply in non-corporate scenarios such as shareholder or partner creditor to company or partnership debtor.

4.11 A disadvantage is that when the debtor cannot utilise the interest deduction, the tax result becomes asymmetric, to the detriment of taxpayers. In this situation the debtor and the creditor themselves may be able to avoid this outcome by amending the terms of the loan to make it interest-free. Submissions on this point are welcome.

4.12 It has been suggested that section DB 31(5) deals with this situation. If so, this section would need to be further clarified in the context of these proposals as its current scope seems too narrow.

4.13 More complex solutions may be available but simplicity has its advantages.

Transitional rule

4.14 The amendment suggested above would only apply prospectively. We may also need to consider past situations when the creditor has taken bad debt deductions for interest accruals when those deductions have not been matched by reversals of expenses by the debtor. This issue will be further considered after the receipt of submissions.

Debt parking

4.15 The Income Tax Act 2007 has several references to "debt parking", as follows:

- The core debt parking rule:
  - section EW 29(8) – BPA forced where debt sold at a discount to associate of debtor;
  - section EW 43 – debt sold at a discount to associate of debtor; and
  - section EW 49 – debt sold at a discount to associate of debtor.

- The consolidated group debt remission rules are in section FM 8(3)(b).

4.16 The core debt parking rule provides that if a debt is acquired by a person associated with the creditor for less than 80 percent of the market value of the debt, calculated as if it is not distressed, then there is an immediate BPA, and the value of the debt is reset. The difference between the acquisition cost and the debtor's carrying value is income to the debtor, and the debt is reset to the acquisition cost in the debtor's books.

4.17 The consolidated group rule provides that intra-consolidated group debt remission is ignored if the debt has always been inside the consolidated group (that is, it cannot have been acquired off a non-consolidated group creditor).

4.18 To ensure that the proposed amendments deal adequately with debt parking issues, the present consolidated group debt parking rule would need to be extended to cover all debt that is affected by the proposals in this issues paper.

Certain dividends

4.19 As noted in Chapter 2, a debt remission from a company to a shareholder causes a dividend which is not subject to the debt remission rules, but rather is a taxable dividend. This overrides the wholly owned group dividend exemption. We consider the principles of this dividend exemption should apply and there should be neither debt remission income nor any taxable dividend income within a wholly owned group of companies.

4.20 However, in other ownership situations an upstream debt remission is conceptually a transfer of wealth and should continue to be regarded as a dividend.

Amalgamations

4.21 Presently, when amalgamations take place between a debtor and a creditor, regard must be had to solvency, and when the debtor is insolvent and unable to meet their obligations, a BPA is performed which results in the debtor having debt remission income. When the companies involved are members of a wholly owned group of companies, this paper's core proposal makes this amalgamations rule redundant and an appropriate consequential amendment would need to be made.

APPENDIX

REPRINT OF QUESTION WE'VE BEEN ASKED QB 15/01

Income tax: tax avoidance and debt capitalisation

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about s BG 1.

Introduction

1. At a tax conference held in November 2013 there was a discussion of whether s BG 1 would apply to certain scenarios. This Question We've Been Asked (QWBA) considers one of those scenarios concerning debt capitalisation. Three other scenarios were the subject of an earlier QWBA: *QB 14/11 Income Tax – scenarios on tax avoidance*, published in October 2014.

2. In the scenario, the arrangement and the conclusion reached are framed broadly. The objective is to consider the application of the general anti-avoidance provision of s BG 1. Accordingly, the analysis of the scenario proceeds on the basis that the tax effects under the specific provisions of the Act are achieved as stated. Also, the specific anti-avoidance provision of s GB 21 is not considered. However, it should not be presumed that this would always be the case. Also, except where shown below, additional relevant facts or variations to the stated facts might materially affect how the arrangement operates and a different outcome under s BG 1 might arise. Accordingly, the Commissioner's view as to whether s BG 1 applies must be understood in these terms.

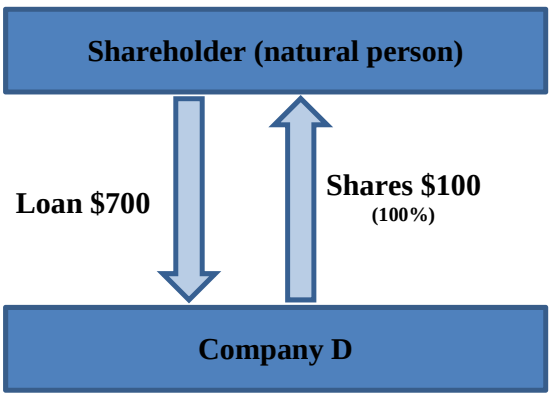
3. Section BG 1 is only considered after determining whether other provisions of the Act apply or do not apply. Where it applies, s BG 1 voids a tax avoidance arrangement. Voiding an arrangement may or may not appropriately counteract the tax advantages arising under the arrangement. If not, the Commissioner is required to apply s GA 1 to ensure this outcome is achieved.

4. For a more comprehensive outline of the Commissioner's position on the law concerning tax avoidance in New Zealand, reference should be made to the Commissioner's Interpretation Statement: IS 13/01 *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (July 2013).

Question

5. Whether s BG 1 applies in the following circumstances:

   - A New Zealand resident individual is the sole shareholder of Company D.
   - Company D is a qualifying company in the following financial position:



Cash	200
Total Assets	**$200**
Shareholder loan	700*
Share capital	100
Accumulated deficit	(600)
Total Equity and Liabilities	**$200**

* The shareholder loan is a "financial arrangement" for the purposes of the financial arrangements rules (FA rules) of subpart EW of the Act and is not part of a wider financial arrangement.

6. Under an arrangement the shareholder and Company D agree that:

- Company D will issue additional shares;
- the shareholder will subscribe $500 for the shares;
- the shareholder's indebtedness to Company D for the share subscription of $500 will be offset against the shareholder loan; and
- the company will repay the $200 balance of the loan in cash.

Answer

7. The Commissioner's view is that s BG 1 would potentially apply to this arrangement.

Explanation

8. The apparent objective of this arrangement is to eliminate the loan owed by Company D to its shareholder in circumstances where Company D issues further shares to that shareholder.

Tax effects

9. The tax effect of the loan ending is that s EW 29(3) requires Company D and the shareholder to each perform a base price adjustment (BPA) under s EW 31 in the income year the loan is eliminated.

10. The BPA is calculated using the formula in s EW 31(5):

consideration — income + expenditure + amount remitted

11. In this scenario, it can be assumed that the income and expenditure items in the BPA formula are zero. The amount remitted item will also be zero for Company D as it is the borrower and unable to remit the debt. The relevant item in the BPA formula for present purposes is "consideration".

12. "Consideration" is relevantly defined as—

> ... all consideration that has been paid, and all consideration that is or will be payable to the person for or under the financial arrangement, minus all consideration that has been paid, and all consideration that is or will be payable, by the person for or under the financial arrangement.

13. The consideration paid to Company D is the original amount of the loan of $700. The consideration paid by Company D is the sum of the $200 paid in cash and the $500 offset against the loan balance. Therefore, Company D's BPA calculation is:

($700 – ($200 + $500)) – $0 + $0 + $0 = $0.

14. The tax effect of the arrangement for Company D is that no income or deduction will arise under the BPA as the calculation returns neither a positive nor a negative figure.

15. Similarly, the tax effect for the shareholder is that there is no income or deduction arising under the BPA as the shareholder's BPA calculation is:

($200 + $500) – $700) – $0 + $0 + $0 = $0.

Parliament's purposes

16. Parliament's purposes for the FA rules is to require income and expenditure under financial arrangements to be recognised by the parties on an accrued basis over the term of the arrangement and to require them to disregard any distinction between capital and revenue amounts. The FA rules provide the tax outcomes for each of the parties to a financial arrangement. In this scenario, this will be the shareholder and Company D.

17. The Court of Appeal in *Alesco New Zealand Ltd v CIR* [2013] NZCA 40 also noted that the financial arrangements rules recognise the economic effect of a transaction. The court stated as follows:

> [71] **In our judgment, the financial arrangements rules were intended to give effect to the reality of income and expenditure – that is, real economic benefits and costs.** They were designed to recognise the economic effect of a transaction, not its legal or accounting form or treatment. The question is whether the taxpayer has "truly incurred the cost as intended by Parliament". [Emphasis added]

18. One issue that arises is whether the parties to a financial arrangement are looked at in combination as a single economic unit. The Commissioner considers that reaching a view on this issue must be derived from the provision in question. While the FA rules are concerned with the overall economic effects of a transaction, in the Commissioner's view, this requires looking at each of the parties involved in isolation. Aside from 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. This conclusion regarding Parliament's purpose for the FA rules does not mean that where other provisions of the Act are in question Parliament may have contemplated a single economic unit perspective was appropriate.

19. Parliament's specific purpose for the BPA is for it to apply as a "wash-up" mechanism which operates when a financial arrangement matures or is disposed of. It operates to account for any gains or losses that have not already been treated as income and expenditure during the life of the financial arrangement. The BPA ensures that for each financial arrangement, all income is returned and all expenditure is deducted.

20. One situation where the BPA applies as a "wash-up" mechanism relevant to this scenario is where ultimately a financial arrangement is not repaid in full. In that case, the BPA formula item "consideration" will be positive for a borrower on account of the consideration received by them being greater that the consideration paid by them. Leaving aside any effect of the other items in the formula (income, expenditure and amount remitted), this would lead to a positive BPA figure. Under s EW 31(3) a positive BPA is income to the borrower (often referred to where there is a debt remission as "remission income"). In the present scenario, had the shareholder of Company D forgiven $500 of the loan instead of subscribing for additional shares, Company D would have had remission income of $500 calculated under the BPA as follows:

($700 – $200) – $0 + $0 + $0 = $500.

21. As a qualifying company, if Company D did not pay the tax on the remission income, the shareholder would have to meet the liability on account of the company (although nothing turns on the company being a qualifying company in terms of the application of s BG 1).

Facts, features or attributes

22. For the FA rules, a fact, feature or attribute Parliament would have expected to see present in an arrangement bringing a financial arrangement to an end is that there has been a discharge in economic terms of the obligations of each of the parties under the arrangement. That is, the borrower has borne the economic cost of repaying the loan and the lender has received an economic benefit.

23. This means that, on the maturity of a financial arrangement Parliament would expect that the consideration paid or payable by a person actually equalled the consideration received or receivable by another person in an economic sense.

24. Where this does not occur, Parliament therefore intended that income will arise for a borrower where an obligation under a financial arrangement, including principal, is forgiven or otherwise unpaid. This is intended to reflect that the borrower has made an economic gain, or has economically had an increase in wealth, by virtue of not having to repay an amount which they would otherwise be required to pay.

Extrinsic material

25. This view is supported by extrinsic materials including the *Final Report of the Consultative Committee on the Taxation of Income from Capital* (The Valabh Committee, October 1992). The committee proposed that debts remitted should be deemed to be repaid in full so that no remission income should arise. However, this proposal was rejected by the Government. In the foreword to that report, the Ministers of Finance and Revenue stated that this proposal was "inconsistent with [Government's] revenue strategy" (at [16]).

26. In a subsequent discussion document, *The Taxation of Financial Arrangements: A Discussion Document on Proposed Changes to the Accrual Rules*, December 1997 (the discussion document), the asymmetrical tax results arising from retaining the debt remission and bad debt rules were stated to be "an inevitable consequence of maintaining a capital-revenue boundary" (at [11.5]). The discussion document also referred to provisions that ignore remission income in the context of consolidated groups as a "substantial concession to the general rule" (at [11.32]).

Commercial and economic reality of the arrangement

27. Next it is necessary to analyse the commercial and economic reality of the arrangement to see whether the facts, features or attributes Parliament would expect to be present (or absent) to give effect to its purpose are present. In the present scenario this requires ensuring Company D has in reality discharged its obligations under the loan when viewed in a commercially and economically realistic way. If so, the tax effects of the arrangement will be within Parliament's contemplation for the FA rules.

28. Company D has discharged its obligations under the loan to the extent of the $200 cash it has paid to the shareholder and this amount is correctly treated as an item of consideration paid in its BPA calculation. Also, on the face of it, it is accepted that consideration for BPA purposes need not be cash but can be money's worth, such as where mutual obligations have been offset. This has occurred in this arrangement to the extent of the $500 share subscription. A financial arrangement is defined in s EW 3(2) in terms of an arrangement involving "money" being provided or received as consideration. The definition of "money" in s YA 1 specifically includes money's worth, whether or not convertible into money, and s EW 31 includes within the BPA calculation all consideration paid to or by the person.

29. However, 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. Given the section at issue, the avoidance inquiry examines whether the loan is in reality repaid, as Parliament would expect where there is no remission income. Therefore, the arrangement is examined to see whether Company D repays the loan in a commercially and economically real sense, and whether the shareholder is repaid in a commercially and economically real sense.

30. In the scenario, there is no actual or economic cost to Company D in issuing shares to the existing shareholder. It has not suffered the full economic cost of repaying the loan. The shareholder, in turn, has not received an economic benefit. There is no change to the shareholder's interest in the company so the shareholder will not receive a "gain" in value from the receipt of the shares commensurate with the face value ascribed to them by the parties. Company D will simply have more shares on issue, and, the existing shareholder will hold more shares in a company in which they already owned all of the shares. The shareholder effectively finances the repayment of $500 of the loan themselves. There is an element of artificiality and contrivance in this aspect of the arrangement.

31. Accordingly, the parties have not given or received full repayment of the loan when viewed in commercial and economic terms. In commercial and economic reality, the effect of the arrangement is that from Company D's perspective it discharges its obligations under the loan thereby eliminating a liability for $700 without it suffering any economic loss or expending money or money's worth beyond the $200 paid. This conclusion does not turn on the fact that Company D is insolvent.

32. When looking at the financial consequences of the arrangement it should be borne in mind that the relevant provision at issue is s EW 31 and the BPA outcome arising for Company D. Parliament's relevant purpose is concerned with a single taxpayer and whether that taxpayer has remission income. As stated at paragraph 18, except for consolidated groups, there is no relevant Parliamentary purpose that provides for the parties to the financial arrangement to be looked at as if they were a single economic unit when determining if remission income has arisen. The FA rules apply to individual taxpayers. When viewed in a commercially and economically realistic way the conclusion is that the loan has, in reality, been remitted by the shareholder to the extent of $500.

33. The Commissioner also considers the commercial and economic reality of the arrangement would be the same even if the shareholder had subscribed for the shares in cash for $500 and Company D had fully repaid the loan in cash.

Applying the Parliamentary contemplation test

34. Accordingly, it is the Commissioner's view that the arrangement does not appear to exhibit the necessary facts, features or attributes that Parliament would have expected to see present to give effect to its purposes for the FA rules and the BPA in particular. Again, in the Commissioner's view, this means the arrangement could be outside Parliament's purposes for the FA rules as it circumvents remission income arising under the BPA. While the Commissioner accepts that arguments could be made to the contrary, on balance, it is considered that the arrangement has tax avoidance as a purpose or effect.

35. It has been suggested that the above conclusion is inconsistent with the view of the High Court in *AMP Life Ltd v CIR* (2000) 19 NZTC 15,940 (HC), where McGechan J commented (at [129]) that a debt capitalisation on its own would not be a tax avoidance arrangement. However, in the Commissioner's view, his Honour's comment does not necessarily reflect a considered judicial view on the issue of debt capitalisation in the context of tax avoidance. The BPA and debt remission income were not at issue in the case, and McGechan J was responding to the arguments before him concerning whether there was actually an "arrangement". The Commissioner also notes that the case was heard and decided prior to the Parliamentary contemplation test being set out authoritatively by the Supreme Court in *Ben Nevis Forestry Ventures v CIR* [2008] NZSC 115. There is no indication that when making his comments concerning debt capitalisation at [129] McGechan J was directly considering what Parliament contemplated for the FA rules in the present context.

Merely Incidental test

36. The next step is to test whether the tax avoidance purpose or effect of the arrangement is merely incidental to a non-tax avoidance purpose or effect. If so, s BG 1 will not apply to the arrangement, even though the arrangement has a tax avoidance purpose or effect. A "merely incidental" tax avoidance purpose or effect is something which follows from or is necessarily and concomitantly linked to, without contrivance, some other purpose or effect.

37. Sometimes, quite general purposes are put forward to explain arrangements, and there is a question how to treat such purposes in the context of the merely incidental test. General purposes that can potentially be achieved in several different ways will not explain the particular structure of the arrangement. Section BG 1, including the merely incidental test, is applied to the specific arrangement entered into. In the present context, the elimination of the shareholder loan or the alleviation of the company's insolvency would be insufficient to explain the particular arrangement and to establish that the tax avoidance purpose or effect is merely incidental to these purposes or effects. This is the situation given the limited facts of the arrangement in this scenario. The tax avoidance purpose or effect appears to be either the sole or the main purpose or effect of the arrangement. Accordingly, the tax avoidance purpose or effect is unlikely to be merely incidental to another purpose or effect of the arrangement and the arrangement in the scenario fails the merely incidental test.

38. However, the Commissioner accepts that in a particular case it may be possible for any tax avoidance purpose or effect of an arrangement involving debt capitalisation to be merely incidental to some non-tax avoidance purpose or effect. If so, s BG 1 would not apply. For this to be the case, the non-tax avoidance purposes or effects would need to explain the involvement of a debt capitalisation within the particular structure of the arrangement. An example may be where a regulatory body imposes a certain approach to the restoration of solvency to a subsidiary.

Reconstruction

39. If s BG 1 is to apply to give rise to remission income for Company D, it might be thought that there should be a corresponding deduction for the shareholder as part of a reconstruction under s GA 1. However, Parliament has made a deliberate choice for the FA rules that sometimes it will produce an asymmetrical result. An asymmetrical result can arise where the lender is not entitled to a deduction. For instance, had the shareholder in this scenario remitted the $500, the shareholder would not have a negative BPA (a negative BPA is a deduction under s EW 31(4)). This is because the BPA formula item "amount remitted" would include any amount not included in the item "consideration" on account of the amount being remitted by the shareholder. This would give a BPA calculation of:

($200 – $700) – $0 + $0 + $500 = $0.

40. For the shareholder to obtain a deduction for remitting the financial arrangement they would need to satisfy the bad debt rules in s DB 31. Relevant to the present scenario, if the parties are associated (as they are here) no bad debt deduction is permitted (s DB 31(3)). To be consistent with this, it would follow that any application of s BG 1 in this scenario would not result in the shareholder being provided with a $500 deduction as a consequential adjustment under s GA 1.

Factual variations

41. This arrangement can be contrasted with the situation where there is an issue of shares to a third party by a solvent company. In that case, it is more likely that the shares issued as consideration will have an economic effect. The existing shareholders of a company would suffer a dilution of their investment. The third party would obtain an equity interest in the company and there may be a change in the effective ownership of the company. This type of situation is more likely to have been contemplated by Parliament as one where no remission income arises under the BPA (although this would need to be considered on a case-by-case basis).

42. Given the above, it might be asked whether the fact that the company is solvent is relevant in the third-party lender situation. The question is answered by considering what facts, features and attributes Parliament would expect to see present. Parliament would expect that a lender receives repayment in a commercially and economically real way. In some situations, depending on the facts, shares in an insolvent company may have some value to a third-party lender. Examples could be where there is the prospect of the company regaining solvency or it has some valuable assets. In most other situations, shares in an insolvent company will not have any value to a third-party lender and so will not constitute repayment of a loan in a real sense.

References

Subject references:

Base price adjustment
Consideration
Debt capitalisation
Debt remission
Financial arrangement
Merely incidental
Tax avoidance
Tax avoidance arrangement

Legislative references

Income Tax Act 2007: ss BG 1, EW 3, EW 29, EW 31, GA 1, s YA 1 definition of "money"

Case references

AMP Life v CIR (2000) 19 NZTC 15,940 (HC)
Alesco New Zealand Ltd v CIR [2013] NZCA 40

Ben Nevis Forestry Ventures Ltd v CIR [2008] NZSC 115

Related rulings/statements

IS 13/01 *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (July 2013)

Other references:

Final Report of the Consultative Committee on the Taxation of Income from Capital (The Valabh Committee, October 1992)
The Taxation of Financial Arrangements: A Discussion Document on Proposed Changes to the Accrual Rules, (December 1997)