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 30 MAY 2014

1. Inland Revenue recently released a draft Question We've Been Asked *Income tax: scenarios on tax avoidance* ("the draft QWBA") with a deadline for comment of 4 July. The four scenarios are concerned with whether the general anti-avoidance provision, s. BG 1 of the *Income Tax Act 2007*, applies.
2. This week I look at the first two scenarios. Next week I will look at the third and fourth scenarios. The topics covered this week are:

   (a) The 3-stage approach;

   (b) Scenario 1: interest deductions on loans to repay a shareholder;

   (c) Scenario 2a: Electing to become a look-through company with dividends taxed at 28%;

   (d) Scenario 2b: Electing to become a look-through company before liquidation.

The 3-stage approach

3. The Commissioner's approach to determining whether an arrangement constitutes tax avoidance follows the approach taken by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 15. In Interpretation Statement IS 13/01 on *Tax avoidance,* the Commissioner refers to this approach as the Parliamentary contemplation test. It is stated in paragraphs 16 to 17 of IS 13/01 that:

   "Applying this test involves identifying:

   - Parliament's purpose regarding the relevant provisions; and
   - The commercial reality and economic effects of the arrangement.

   The Commissioner considers that the better approach is to identify Parliament's purpose for the relevant provisions first, even though it is recognised that these two aspects of the Parliamentary contemplation test are interrelated and inform each other."

4. The approach to interpreting the specific provisions (the first part of the test) is discussed in paragraphs 55 to 85 of IS 13/01. The economic substance of the arrangement is not considered at this stage of the inquiry. It is stated in paragraph 82 that:

   "The approach to interpreting provisions of the Act should give proper effect to Parliament's intention for those provisions. The approach is to ascertain the meaning of an enactment from its text and in the light of its purpose. This is done by giving the words their ordinary meaning and taking into account the purpose of the legislation and its context, and, where

appropriate, extrinsic materials, in accordance with normal statutory interpretation principles."

5. If the specific provisions have been used according to Parliament's intention for those provisions, the analysis of the arrangement moves to the second stage, which is looking at whether the arrangement constitutes tax avoidance when the commercial reality and economic effects of the arrangement are viewed as a whole. The third stage is to consider whether tax avoidance is merely an incidental effect of the arrangement.

6. The Commissioner's approach to nullifying the tax avoidance effect proceeds in two stages (paragraph 31 of IS 13/01):

   (a) First, the arrangement is voided under s. BG 1;

   (b) Second, if the voiding of the arrangement has not appropriately counteracted the tax advantage, the Commissioner will apply s. GA 1 and adjust taxable income so as to counteract the tax advantage.

7. The tax scenarios discussed in the draft QWBA all proceed on the basis that the tax effects under the specific provisions of the Act are achieved as stated. However, the conclusions are not to be taken as a "fait accompli" in similar situations, because every situation depends crucially on the particular facts.

Scenario 1: interest deductions on loans to repay a shareholder

8. A trust that owns a company has advanced the company $1m in shareholder loans. The company uses the loans in its business operations for the purpose of deriving assessable income. The company borrows from a third-party lender at arm's length market interest rates to repay the shareholder loans to the trust. The company's loan is secured over the trust's assets. The trust uses the money from the repaid loans to buy a holiday home for use by the trust's beneficiaries.

9. The company deducts the interest payable to the third-party lender. The question is whether this amounts to tax avoidance. The answer is that it is not tax avoidance.

10. A company is allowed a deduction for interest incurred under s. DB 7, providing that it is not a qualifying company. It is stated in paragraphs 9-10 and 12 of the draft QWBA that:

    "Generally, for interest deductions Parliament intended interest to be deductible where the loan capital relating to that interest is used in a business or in some other way in the production of assessable income (s DB 6, *Pacific Rendezvous Ltd v CIR* [1986] 2 NZLR 567 (CA)).

    Parliament has also distinguished between some companies and other taxpayers in respect of interest deductions. Significantly, interest incurred by some companies is deductible under s DB 7 without the need to establish a nexus between the borrowing and carrying on a business or deriving assessable income. …

    Accordingly, in an arrangement involving interest deductions, Parliament would expect to see, as matters of commercial and economic reality, borrowing by a company with attendant interest liabilities in circumstances where there is either compliance with s DB 7 or sufficient nexus or connection with a business or income-earning activity. Also, the interest deductions claimed should not be related to private or domestic expenditure."

11. In this case, the fact that the loan is secured over the trust's assets is immaterial. The loan is used for business purposes.

12. The deductibility of interest on money borrowed to repay loans to shareholders is not a new policy:

    (a) In the Commissioner's 1992 Interpretation Statement on *Interest Deductibility* on pages 14-18 of *Tax Information Bulletin* Vol. 3, No. 9 (June 1992), Example 10 concerns a company in business borrowing to repay a loan from a shareholder. The interest is said to be deductible.

    (b) In BR Pub 10/14 – 10/19 *Interest Deductibility – Roberts and Smith – Borrowing to replace and repay amounts invested in an income earning activity or business*, interest is deductible under BR Pub 10/18 if it is payable on borrowings used to replace debt used in an income-earning activity.

13. The form of the transaction is relevant. *Borlase* v *C of IR* (2001) 20 NZTC 17,261 (HC) concerned money borrowed to purchase a new private residence, while a former residence was rented out. A small portion of the new borrowing was secured against the former (rented out) residence. The High Court agreed with the Commissioner that only the interest on the small portion of the loan secured against the property rented out was deductible. The same conclusion was reached in *Case N63* (1991) 13 NZTC 3,483 where interest on money to purchase a new apartment was not deductible even though it allowed a former apartment to be retained and rented out.

14. It is possible to argue for deductibility due to the retention of an income-producing asset that would otherwise have to be disposed of, based on *Public Trustee* v *C of T* [1938] NZLR 436, discussed in Interpretation Statement IS0082 "Interest deductibility — Public Trustee v CIR" in *Tax Information Bulletin* Vol. 18, No 6 July 2006 at 9). The Commissioner considers that interest on borrowings will be deductible when the borrowed funds retain income earning assets, if the taxpayer can establish that:

    (a) The liability that the borrowed funds were used to discharge was involuntary; and

    (b) The taxpayer definitely would have realised particular income earning assets, if the taxpayer had not borrowed, and

    (c) The liability that the borrowed funds were used to discharge arose in connection with the income earning assets retained.

15. However, following *Borlase* and *Case N36* it will be far easier to support interest deductibility by borrowing directly to fund income-earning assets.

Scenario 2a: Electing to become a look-through company with dividends taxed at 28%

16. A profitable company with significant reserves is owned equally by two trusts, one of which operates a farming business and incurs tax losses. The company has sufficient imputation credits to fully impute all dividends at 28%. An election is made to turn the company into a look-through company ("LTC") and transfer the reserves into fully tax-paid owner investments at 28% under the conversion formula in s. CB 32C. These are then distributed to owners in the first year after attaining LCT status.

17. The particular avoidance issue in this scenario is whether the use of the election to enter the regime, the one-off payment of tax on company reserves under s CB 32C on entry to the

regime, and subsequent tax-free distributions of the reserves, is within Parliament's contemplation.

18. If the reserves had been distributed without converting the company into an LTC, the shareholders would have been required to pay tax on dividends at their marginal tax rates. As the shareholders in the arrangement are trustees, they would have had to have paid tax at the higher trustee rate of 33%. On the other hand, any shareholders with a marginal tax rate of less than the company tax rate would have excess imputation credits able to be carried forward to subsequent years and offset from future tax liabilities.

19. The answer to the avoidance question is that, in this case, there is no tax avoidance because:

    (a) Parliament contemplated existing companies electing into the LTC regime but the treatment of reserves under the LTC regime was not intended to apply to company reserves previously accumulated by existing companies.

    (b) Because of this, a mechanism is needed to ensure tax is paid on existing company reserves when a company enters the regime. This mechanism is provided by s CB 32C.

    (c) Under s CB 32C in the first year after the election:

        (i) The shareholders of existing companies pay tax at the company tax rate on a one-off basis on the company's unimputed reserves that existed at the time of the company becoming an LTC; and

        (ii) Therefore, in the first year after the election the shareholders do not pay tax on company dividends at their marginal tax rates.

    (d) Parliament's purpose, as expressed elsewhere in the Act and in the way the LTC regime applies to new companies or existing companies after the initial year, shows that it generally intends profits earned through a company to be taxed at a shareholder's marginal tax rate.

    (e) However, the Commissioner's view is that Parliament has made an exception to its general approach of taxing company profits distributed to shareholders at the shareholders' marginal rates in the case of the first year following an existing company electing LTC status.

20. There is some further "gloss" added to support the "appropriate" use of a statutorily clearly available tax benefit:

    (a) Apparently, in the Commissioner's view there are "circumstances Parliament would expect to be present where an existing company elects to enter into the LTC regime" and these circumstances are present in this arrangement when the arrangement is viewed as a whole.

    (b) It is stated further that "as matters of commercial and economic reality there is a closely-held company that is carrying on a business that satisfies the requirements of entering into the LTC regime".

    (c) Also noted is that "the types of factors mentioned by the court in *Ben Nevis* (at [108]), such as artificiality or contrivance, do not appear to be present in this case. If those factors were present, they could indicate the LTC regime requirements are not met when the arrangement is viewed in a commercially and economically realistic way".

Scenario 2b: Electing to become a look-through company before liquidation

21. This scenario involves the conversion of the same company (as in scenario 2a) into an LTC. However, at the time of electing LTC status, Company B's directors had contracted to sell the company's business and resolved to liquidate the company once the sale is settled. The sale of the business is settled, the company liquidated with surplus assets distributed to shareholders, and the company is removed from the register of companies after the LTC election was effective.

22. The Commissioner considers this arrangement would constitute tax avoidance, in fact "in the Commissioner's view, it is strongly arguable that this arrangement is outside Parliament's contemplation for the LTC regime and how the Act should apply to a company that is winding-up" because:

    (a) Parliament's purpose for the LTC rules is only given effect where a company continues to operate: "several features of the rules anticipate the future tax treatment applicable to LTCs or its shareholders, for instance, the one-off payment of tax on reserves under s CB 32C and the one-off adjustment extinguishing losses that apply upon a company's entry to the regime. It is also notable that a company only retains LTC status if it continues to meet the eligibility criteria. The benefits of the rules are intended to be accessed only by companies with certain characteristics and who continue to have those characteristics. … Therefore, the Commissioner's view is that a fact, feature or attribute Parliament is likely to expect to see present in order to give effect to its purposes for the LTC regime is that the election and one-off payment of tax is available where the LTC is ongoing."

    (b) Electing into the LTC regime is an unnecessary step in winding up the company: "in commercial and economic reality, there is effectively no operating company in this scenario. Instead, the objective of the arrangement seems to be to wind up Company B. The arrangement is artificial or contrived as obtaining LTC status is an unnecessary step in achieving that objective and it serves only to ensure the winding-up occurs in the most tax advantageous way. This would also be true even if there was an amount of time between the LTC election and the winding up of the company. The key is whether the arrangement comprises both the winding-up of the company and an LTC election."

    (c) The arrangement circumvents the rules for taxation of dividends upon winding up a company: "Parliament's purpose for companies that are winding-up is for certain amounts to be taxable as dividends. However, Parliament contemplates that LTCs are not subject to these provisions. Accordingly, the election of Company B into the LTC regime circumvents Parliament's purpose for the application of the dividend rules to companies that are winding-up."

Arun David, Director

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