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WEEKLY COMMENT: FRIDAY 6 JUNE 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. Last week I looked at the first two scenarios. This week I look at the third and fourth scenarios.

3. First, however, I would like to point out a couple of comments on the "merely incidental" test (the third stage of the *Ben Nevis* approach) made by Justice Susan Glazebrook in her paper on *Statutory interpretation, tax avoidance and the Supreme Court: reconciling the specific and the general* presented at the NZICA Tax Conference in November 2013. In my view these comments are worth remembering in relation to the tax advantage arising from imputation credits when converting to a look-through company discussed last week:

   (a) First, Justice Glazebrook referred, at p. 14, to Woodhouse P's dissenting judgment in the Court of Appeal in *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513:

   "As a matter of construction, Woodhouse P considered that the phrase "merely incidental" in the context of s 99 points to something which is necessarily linked and without contrivance to some other purpose or effect so that it can be regarded as a natural concomitant of that other (legitimate) purpose or effect."

   (b) Later, she stated, at p. 18, that:

   "It has been noted, however, that the purely incidental test, as expressed by Woodhouse P, is not a totally satisfactory (way) of dividing legitimate transactions from tax avoidance arrangements. This is because there are a number of situations in which arrangements with tax as their main purpose will be perfectly acceptable uses of specific provisions under the Act. For example where a taxpayer places an investment in a Portfolio Investment Entity (PIE) scheme) in order to obtain a lower tax rate, the taxation consequence, far from being a merely incidental purpose, is the sole purpose of the transaction."

Scenario 3: substituting debentures

4. This scenario involves an issue of debt by a company to its shareholders in a manner that potentially circumvents the substituting debenture rule in s. FA 2(5), which applies to debentures issued to a shareholder in proportion to the number of shares or available

subscribed capital held. The rule denies a deduction to the company for any expenditure incurred in connection with the debenture. Convertible notes are explicitly excluded from being substituting debentures for the purpose of the rule.

5. The rule is to be repealed from 1 April 2015. Clause 84 of the *Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill* will, when enacted, repeal s. FA 2(5) with effect from 1 April 2015, unless a taxpayer has previously obtained a binding ruling which the taxpayer elects, before 31 July 2014, to continue to apply.

6. The Commissioner's reasons for commenting on this scenario are as follows:

   "Nevertheless, it is considered useful to comment on this scenario as it illustrates the application of s BG 1 where a provision's purpose has become less clear over time. In such situations, the Commissioner considers that the text of the provision, supported by the scheme of the Act, will generally be the key determinant of Parliament's purpose."

7. The terms of the shareholder debt (issued in proportion to shares held), in this example, provide that on the occurrence of an insolvency-type event, the company has the option to convert the debt into shares having a net asset value equal to the face value of the loan. Therefore, the exclusion for a convertible notes applies and a deduction for expenditure on the debt is not denied by the substituting debenture rule. The Commissioner's view is that the arrangement constitutes tax avoidance.

8. The main focus of the discussion is on whether the convertibility feature results in changing the effective ownership of the company. The Commissioner draws on the High Court and Court of Appeal decisions in *Alesco New Zealand Ltd v CIR* [2012] 2 NZLR 252 (HC) and *Alesco New Zealand Ltd v CIR* [2013] NZCA 40 (CA) to support his assertion that the convertibility feature exists purely in order to circumvent the rule in s. FA 2(5). In the *Alesco* case, the Commissioner's argument that a convertible note issued at a discount was in effect an interest-free loan relied heavily on there being no issue or transfer of shares to any external party.

9. In my opinion, the main point of the discussion, given that the substituting debenture rule is being repealed, is to emphasise the Commissioner's view in *Alesco* that convertibility of a note should result in an issue or transfer of shares to an external party in order to be a bona fide feature of the arrangement.

10. The Commissioner's arguments supporting tax avoidance are that:

    (a) Parliament's purpose in relation to the substituting debenture rule is that debt issued in proportion to shares should be reclassified as equity;

    (b) In an arrangement where s FA 2(5) does not apply, Parliament would expect to see either:

        (i) Debentures that as a matter of commercial and economic reality have not been issued to shareholders in proportion to their shareholdings; or

        (ii) Convertible debentures that have some prospect of changing the effective ownership of the company on a conversion.

    (c) In the example given, the convertibility feature of the debt is artificial and contrived because, there will be no effective change in the ownership of the company.

(d) The tax avoidance purpose or effect is not merely incidental to another purpose or effect of the arrangement such as the purpose of assisting the solvency, because such a general purpose does not explain the particular structure of the arrangement.

Scenario 4: debt capitalisation

11. The example given is of a qualifying company to which a shareholder has lent $700. However, the company only has assets, consisting of cash, of $200. Instead, the company agrees to pay the shareholder $500 and the shareholder subscribes for additional shares in the company equal to $500, and the two amounts are offset so that no cash changes hands.

12. If, instead, the company paid the $200 it has, and the shareholder were to forgive the remainder of the loan, the company would have remission income, under the financial arrangements ("FA") rules, of $500. The shareholder would not have a corresponding tax deduction because:

    (a) An amount that is remitted is deemed to be paid for the purposes of the base price adjustment ("BPA") in the financial arrangements rules; and

    (b) A deduction for a bad debt is denied in circumstances where the lender and the borrower are associated persons.

13. In the example given, the company has no remission income because the debt is fully repaid. The Commissioner's view is that this amounts to tax avoidance because the apparent objective of the arrangement is to eliminate the loan in circumstances where the company is unable to repay it. "In the Commissioner's view, this arrangement is potentially outside Parliament's purposes for the FA rules as it circumvents remission income arising under the BPA." Moreover, the tax avoidance purpose or effect appears to be either the sole or the main purpose or effect of the arrangement, so it is unlikely to be "merely incidental".

14. Once again, the Commissioner has resorted to the argument that there has been no issue of shares to an external party: "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."

15. The Commissioner's arguments in support of tax avoidance, some of which are drawn from the Court of Appeal judgment in *Alesco* are as follows:

    (a) 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.

    (b) 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.

    (c) One situation where the BPA applies as a "wash-up" mechanism is where ultimately a financial arrangement is not repaid in full.

    (d) Parliament therefore intended that income will arise for a borrower where an obligation under a financial arrangement, including principal, is forgiven or otherwise unpaid.

    (e) For a nil BPA outcome to arise on the maturity of a financial arrangement as it has in this scenario, Parliament would expect that the consideration paid or payable by a person

actually equalled the consideration received or receivable by the person in an economic sense.

(f) The Court of Appeal in *Alesco* noted that the financial arrangements rules "were designed to recognise the economic effect of a transaction, not its legal or accounting form or treatment".

(g) The definition of "money" includes money's worth, therefore, under the FA rules the issuing of shares by a company is "consideration paid" by that company, and this must have been intended by Parliament.

(h) The shares are being issued to the sole shareholder. There is no actual or economic cost to the company in issuing shares to the existing shareholder. The company 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.

(i) The shareholder will not receive the full loan amount lent in commercial and economic terms. There is an element of artificiality and contrivance in this aspect of the arrangement. In reality, to the extent of the $500, the loan has been repaid only through the mechanism of the shareholder effectively providing the funds themselves by subscribing to shares that are all but valueless in their hands.

(j) Parliament's relevant purpose is concerned with a single taxpayer and whether that taxpayer has remission income. The FA rules apply to individual taxpayers. From a commercially and economically realistic viewpoint the loan has been remitted by the shareholder to the extent of $500.

16. The Commissioner's analysis is worrying in three significant respects. First, it completely ignores the existing body of case law, which supports there being full consideration provided by the company for the repayment of the debt through the issue of the shares.

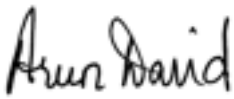
(a) In *Stanton (HMIT)* v *Drayton Commercial Investment Co Ltd* 82 BTC 269 the House of Lords was of the view that the payment for shares equaled the amount subscribed.

(b) This was followed in *Pro-Image Studios v Commonwealth Bank of Australia* (1991) 4 ACSR 586, which concerned whether an insolvent company issued its shares at a discount when it issued shares in repayment of a debt owed of $46.3 million. The Supreme Court of Victoria confirmed that it is the debt which is released which counts and not some assessed value to the creditor of the debt owed to him or her based upon prospects of realisation or execution of, or upon, the debt.

(c) *Re Keith Bray Pty Ltd* (1991) 5 ACSR 450 followed the *Pro-Image* decision that the issue of shares in discharge of a debt owed by the issuer is likely to be regarded as being for full consideration even if the issuer is insolvent. The capitalisation is effected on the basis of the nominal amounts of the debt and shares and not some assessment of their value.

17. Second, the Commissioner's argument appears to treat the two taxpayers as a single taxpayer, despite the explicit statement that the FA rules apply to individual taxpayers. The Commissioner states that nothing turns on the company being a qualifying company, but notes that the shareholder would be liable for the company's tax if the company defaulted on payment. Clearly, the shareholder will not gain from the transaction, and the shareholder's economic position is not enhanced as a result of subscribing for the shares. However, the company's economic position is enhanced. The company receives capital and repays debt. Its liability is converted into equity in a real economic sense. It is not a "legal or accounting form or treatment". Parliament did not contemplate taxing a gain made in that sense.

18. Third, as a result of the use of the argument about there being no external party involved, the Commissioner is reading requirements into the FA rules which simply do not exist. A "factual variation" provided, where there would be no avoidance, involves an issue of shares by an insolvent company to a third party. There is no such requirement in the FA rules. In my opinion, the Commissioner would have trouble sustaining these arguments in Court.



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