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WEEKLY COMMENT: FRIDAY 17 APRIL 2015

1. This week I look at the proposals for changes in *Related parties debt remission – An officials' issues paper* ("the Issues Paper") released on 24 February. As noted last week, the proposals aim to do away with debt remission income that arises on certain related party transactions under current law.

2. The proposals in the Issues Paper concern:

   (a) Debt capitalisation inside a wholly owned group;

   (b) Corporate debtor with a non-corporate single New Zealand shareholder;

   (c) Corporate debtor and pro rata debt capitalisation;

   (d) Partners (including LTC owners and limited partners) advances to partnerships;

   (e) Outbound investment into a wholly owned CFC;

   (f) The non-resident inbound investment scenario;

   (g) Bad debt deductions for accrued interest; and

   (h) Consequential amendments to other rules.

Debt capitalisation inside a wholly owned group

3. It is noted that:

   (a) Within a wholly owned group, 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;

   (b) If the parties are in the New Zealand tax base, debt and equity are generally economically substitutable, because the imputation regime generally produces this result (although in Australia the *Re:think Tax Discussion Paper* released on 30 March 2015 noted, in Chapter 5 section 5.2, that the imputation system introduced certain biases and questioned whether it is continuing to serve Australia well).

4. Reasons advanced to support the conclusion that the asymmetric debt remission tax result should not generally apply in the intra-group situation when all companies are resident in New Zealand are:

   (a) The rules around intra-group debt remission are an apparent inconsistency between the consolidated group rules and the rules for a group of companies that is wholly owned but not a consolidated group;

(b) There seems to be a public benefit argument: if intra-group debt is advanced to pay off third party creditors, the tax system should not penalise a subsequent debt capitalisation;

(c) The timing should not matter: if a capitalisation is not avoidance if undertaken to start with, a later debt capitalisation should also not be avoidance; and

(d) There is a current bias towards liquidating an insolvent subsidiary because in that case no extra tax is payable, and there is no reason for this bias towards liquidation as opposed to debt remission or capitalisation.

5. The preferred solution in the Issues Paper is to "turn off" debt remission income, rather that allow the creditor a deduction. Within the wholly owned group scenario, there would be potential for an "extra" deduction if the debtor is liquidated without paying the tax and the creditor is allowed a deduction.

6. Within the wholly owned group scenario considered above, officials are of the view that there should be no dividend if debt is remitted by the company as discussed above. The principles of the wholly owned group dividend exemption should apply to dividends arising as a result of debt remission.

Corporate debtor with a non-corporate single New Zealand shareholder

7. Under current rules, if an individual or a trust wholly owns a company, and has lent money to it, the remission of the loan will give rise to income under the base price adjustment ("BPA") and the creditor will be denied a deduction for a bad debt.

8. However, the situation is no different from that discussed above for companies in a wholly owned group: the shareholder's wealth is unchanged as a result of remitting the debt owed by their wholly owned company.

9. Therefore, the preferred solution in this case is to "turn off" debt remission income being derived by the shareholder.

10. Officials hasten to add that if the debt is owed by the shareholder, debt forgiveness should continue to be taxed as a dividend. This situation is distinguished from the wholly owned group situation because an upstream debt remission is conceptually a transfer of wealth and should continue to be regarded as a dividend.

Corporate debtor and pro rata debt capitalisation

11. The circumstances in this scenario are described specifically as follows:

(a) Shareholder debt is pro rata to ownership;

(b) The debt is all held by New Zealand resident shareholders; and

(c) The debt remission (either directly or via debt capitalisation) is also pro rata.

12. The proposal is that there should be no debt remission income in these circumstances (i.e. debt remission income should be "turned off") because:

(a) The shareholders have simply swapped some debt for equity; and

(b) The owners' "consolidated" wealth has not changed from what it was before the debt remission or capitalisation.

13. Again, the dividend rules would continue to apply in the reverse situation, if the company were to forgive debt owed by shareholders.

Partners' (including LTC owners and limited partners) advances to partnerships

14. The term "partnership" in the Issues Paper is stated to include look-through companies ("LTCs") and limited partnerships.

15. The proposal is to "turn off" debt remission income in circumstances where the debt is remitted or capitalised pro rata to the ownership by the partners, look-through company owners, or limited partners.

16. However, officials have questioned whether some debt remission income should be "turned off" even when partnership debt is not remitted pro rata. While there is a genuine transfer of wealth among the partners in this case, it may not be appropriate for a partner who suffers a non-deductible loss to also suffer their share of the associated remission income.

Outbound investment into a wholly owned CFC

17. At present, a CFC that enjoys an active income exemption could potentially become passive as a result of debt remission income if debt is remitted or capitalised. In that case there would be attributed income as a result of debt remission.

18. Officials have proposed that there should be no debt remission income for a CFC if CFC owners' debt is remitted or capitalised pro rata to the owners.

19. It is noted that conceptually a CFC is inside the New Zealand tax base because it is owned by New Zealanders (ignoring FIF interests), and the fact it may not be subject to tax in New Zealand due to the active income exemption does not present any unexpected or inappropriate tax results.

The non-resident inbound investment scenario

20. In this case, the owner/creditor is a non-resident and the debtor is a New Zealand resident. There are no proposals relating to this scenario. Policy analysis is still underway and officials have invited submissions.

21. It is noted that, in principle:

    (a) The owner's economic wealth is unchanged as a result of remitting debt owed by a wholly owned New Zealand subsidiary; and

    (b) The New Zealand tax base is no worse off, and may be better off, because dividends are paid out after tax.

22. However, there is concern that:

    (a) The debt/equity boundary may be more easily pushed to the limit in the knowledge that debt can quickly and easily be converted into equity; and

    (b) Interest that cannot be paid could be capitalised and subsequently converted into equity.

Bad debt deduction for accrued interest

23. Officials are concerned about a present loophole in the bad debt deduction rules. There are no restrictions on a parent company claiming a bad debt deduction for interest income due from

a subsidiary. The subsidiary, on the other hand, can continue to accrue interest expenditure, which could be made available to other group companies by way of a loss offset. This results in an intra-group deduction without any corresponding income.

24. The proposal in this case is to disallow a deduction for associated persons interest receivable. Moreover, the disallowance of the creditor's bad debt deduction will not be dependent on whether the debtor has used the interest deduction, because it would be difficult to know whether it could be used in a later year.

25. The solution would also apply in non-corporate scenarios such as shareholder or partner creditor to company or partnership debtor.

26. Officials are not concerned about the potential for an asymmetric result if the debtor cannot use the deduction, because the parties could amend the terms of the loan and make it interest-free.

27. Officials are not convinced s. DB 31(5) deals adequately with this situation. As noted last week, s. DB 31(5) limits a deduction for a bad debt owed by a company to another company to the extent to which it exceeds any tax loss offset between the creditor company or another company in the same group involving the tax loss that arose from the use of the debt.

28. Section DB 31(5) deals only with inter-company debts and tax losses that arose from the debt in years before the debt was written off. Officials have stated the current scope of s. DB 31(5) is too narrow and the section would need to be clarified.

29. Officials have also suggested looking at past situations so that the proposal did not only apply prospectively. A transitional rule would be required.

Consequential amendments

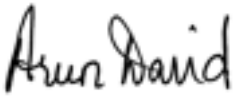
30. Apart from the above situation involving bad debt deductions for interest, officials are not concerned about tax losses being affected by related party debt remission.

31. There are three other areas where amendments to existing legislation will be required:

    (a) The "debt parking" rules discussed last week would need to be amended so that they did not apply in circumstances where there would be no debt remission income. The proposal is for the existing consolidated group exemption (also discussed last week) to be extended so as to apply to all debt affected by proposals in the Issues Paper.

    (b) The wholly owned intra-group dividend exemption would need to be extended so as to apply to dividends arising as a result of debt remission where there would be no income under the proposals in the Issues Paper.

    (c) The rule requiring amalgamating companies with intra-group financial arrangements to consider the solvency of the debtor company (also discussed last week) would be redundant in circumstances where there would be no debt remission income within a wholly owned group under the proposals in the Issues Paper.



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