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WEEKLY COMMENT: FRIDAY 17 NOVEMBER 2017

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

2. This week I complete looking at the amendments to the related parties debt remission rules.

Deemed debt capitalisation upon debt remission

3. Section EW 46C(2)(a) states that the means by which the debt is forgiven is immaterial. For a company, a common means employed is to capitalise the company with sufficient funds to repay the debt.

4. The amount of capital for tax purposes, referred to as available subscribed capital ("ASC") is given by the formula in s. CD 43(1), and essentially consists of amounts subscribed ("subscriptions") reduced by amounts redeemed ("returns").

5. Section CD 43(6)(c) states that the subscriptions amount includes, in the case of shares issued on conversion of, or as consideration for the release of, a debt claim against the company, the amount of debt converted or released.

6. It is stated on page 109 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 ("the TIB Item") that conceptually, qualifying debt remission should also create ASC where the creditor has ownership interests in the debtor.

7. New sections CD 43(6B), (6C) and (6D) have been inserted so that debt forgiven to which new c. EW 46C applies will result in a deemed increase in ASC, in specified circumstances, for:

   (a) Wholly-owned groups, where the creditor company is a non-resident; and

   (b) For non wholly-owned groups.

8. For a wholly-owned group, new s. CD 43(6B) covers situations where inbound debt (in the case of a non-resident owner who is also the creditor) is deemed to have been repaid, and:

   (a) The requirements of either s. EW 46C(1)(a) or (b) are met – i.e. the debtor company is a New Zealand resident company or is a non-resident company that is directly wholly-owned by a group of New Zealand resident companies; and

(b) The creditor is a non-resident company in the same wholly-owned group; and

(c) The exception in s. EW 46C(3) does not apply - i.e. the debt has not been previously held by a person that is not a member of the wholly-owned group of companies.

9. Where these requirements are met, new s. CD 43(6D) states that the ASC relating to the class of shares that the creditor has the most voting interests for is deemed to be increased as follows:

(a) If the company with the increased ASC is the debtor company itself (i.e. the creditor directly holds shares in the debtor), the ASC is deemed to be increased by the amount of the debt treated as having been paid to the creditor;

(b) If the company with the increased ASC is a company that holds shares in the debtor (i.e. the creditor company does not directly hold shares in the debtor company), the ASC is deemed to be increased by the proportion of the debt reflecting the company's percentage shares (or market value interests, as appropriate) in the debtor.

10. For a non wholly-owned group, new s. CD 43 (6C) states that if s. EW 46C(1)(c) applies – i.e. the debtor is a company, and the creditor is not a member of the same wholly-owned group of companies as the debtor, but the creditor does have ownership interests or, as applicable, market value interests in the debtor, new s. CD 43(6D) similarly applies, so that the ASC relating to the class of shares that the member of the single creditor group has the most voting interests in is deemed to be increased as follows:

(a) If the company with the increased ASC is the debtor company itself (i.e. the single creditor group directly holds shares in the debtor), the ASC is deemed to be increased by the amount of the debt treated as having been paid to the creditor;

(b) If the company with the increased ASC is a company that holds shares in the debtor (i.e. the single creditor group does not directly hold shares in the debtor company), the ASC is deemed to be increased by the proportion of the debt reflecting the company's percentage shares (or market value interests, as appropriate) in the debtor.

11. The restriction of the deemed creation of ASC to wholly-owned groups only where the creditor is a non-resident company is explained on page 109 of the TIB Item as follows:

" … in the wholly-owned group situation … if the parties want to create ASC by debt capitalisation or similar, they may, but any compulsory imposition of the creation of ASC in this situation seems unnecessary (and can be complex).

Accordingly the provision of ASC for debt remission is limited to situations outside the wholly-owned group debt remission … The one exception to excluding the wholly-owned group debt remission from creating ASC is where the debtor is directly owned by non-resident wholly-owned group companies and the debtor is also non-resident (and the New Zealand company has no ownership interests in the non-resident owner or the debtor). In this case the creation of ASC is simple and, because of the direct non-resident ownership, is warranted.

… the ASC is increased for the corporate debtor by the amount remitted. Where there are companies in the wholly-owned group between the debtor and the non-resident creditor their ASC is also increased pro rata to their ownership interests in the debtor."

Shareholder's cost base after a debt remission capitalisation

12. New s. DV 18B sets out the cost base for shareholders in a company in which ASC is deemed to be increased under the rules set out in ss. CD 43(6B) to (6D), as discussed above.

13. The deemed subscriptions amount under s. CD 43(6D) is treated as expenditure incurred for the purchase of the shareholder's shares in the calculation company.

14. The maximum expenditure for the shareholder's shares is the subscriptions amount under s. CD 43(6D) for the company multiplied by the shareholder's voting interest (or market value interest, as appropriate) in the company.

Debt remission will not result in a capital gain amount

15. A new s. CD 44(8B) has been inserted, which states that when debt is forgiven in an economic group under s. EW 46C, the debt forgiven will not give rise to a capital gain if it does not give rise to deemed ASC under s. CD 43(6D).

16. This limitation is explained on page 109 of the TIB Item as follows:

"In a number of cases the application of s. EW 46C to the remission of the debt of a company will not cause that company to have ASC. To limit the planning opportunities s. CD 44 has been amended to ensure that any 'capital gain amount' does not include a gain made by a debt remission that qualifies for s. EW 46C relief."

Bad debts amendments

17. The bad debt amendments apply from 1 July 2017. The amendments are only partially related to new debt forgiveness rules. They have a more general remedial effect.

18. Section DB 31 allows a deduction for a debt that is written off as bad in the income year, providing various requirements are met.

19. For a bad debt relating to an amount owing in respect of a financial arrangement, s. DB 31(2) contained the following additional requirements:

(a) The amount must be attributable to the income from the financial arrangement; and

(b) The amount cannot have given rise to a tax loss of the debtor company that is used in the group of companies to which the creditor company belongs.

20. New additional requirements have been inserted as s. DB 31(2) as s, DB 31(2)(bb): The creditor seeking to deduct the bad debt:

(a) Must not be not associated with the debtor; or

(b) If associated with the debtor, the debtor has no deductions for the financial arrangement.

21. The latter concession where the debtor has no deductions for the financial arrangement allows a deduction for a bad debt if the associated person debtor is not in the New Zealand tax base.

22. This addressed the situation where a double deduction could be obtained through the debtor having an interest deduction and the creditor having a bad debt deduction.

23. It is noted on page 108 of the TIB Item that where the debt remission rule in s. EW 46C applies, the debt is deemed to be repaid and any bad deduction previously claimed is recovered, therefore the amendment denying the bad debt merely removes the timing advantage (of having an initial bad debt deduction and then income in a s subsequent year when the debt is deemed to be paid).

24. Effective from 1 July 2017, a new s. EW 46C(2)(ab) states that the debt forgiven includes an amount accrued and unpaid at the time of the forgiveness. This will ensure that as from 1 July 2017, accrued interest is deemed to be repaid and any bad debt deduction is recovered.

25. It is noted on page 108 of the TIB Item that the 1 July 2017 application date means that any bad debt write-off of interest accrued before 1 July 2017 is not automatically reversed by the application of the general provisions of s. EW 46C to the debt.

Guarantees of loans

26. The loan guarantee amendments also have a general remedial effect. Effective for the 2017-18 and later income years, a new s. EW 49B has been inserted which applies, when a guarantor pays a "guarantee payment" under a guarantee for an associated person's debt to the debtor's creditor, as follows:

    (a) Section EW 49B(2) states that for the debtor, the amount of the guarantee payment is treated as consideration paid or payable by the debtor for the debt;

    (b) Section EW 49B(4) states that for the guarantor, the guarantee payment is treated as not being consideration paid or payable by the guarantor;

    (c) Section EW 49B(3) states that if the guarantor has recourse to the debtor in relation to the guarantee payment, the guarantor is treated as providing the debtor with an interest-free loan for the amount of the guarantee payment; and

    (d) Section EW 49B(5) states that if the debtor later repays the guarantor more then the guarantee payment, the excess paid by the debtor is:

        (i) Income of the guarantor under the financial arrangements rules; and

        (ii) A deduction that the debtor is allowed under an amendment to s. DB 13(1).

27. It is stated on pages 109-110 of the TIB Item that these amendments address the concern that a guarantor can obtain a tax deduction for a payment under a guarantee of an associated person's debt. The guarantor is denied a tax deduction under s. EW 49B(4) because the guarantee payment is treated as not being consideration paid or payable by the guarantor.

28. Where the guarantee payment extinguishes the debtor's original loan, the base price adjustment ("BPA") will produce income to the debtor of any difference between the loan balance owed immediately before the guarantee payment was made.

29. If the guarantor has recourse, s. EW 49B(5) provides for income for the guarantor and a deduction for the debtor of any excess repayment to the guarantor. If, however, the debtor is liquidated before repayment of the deemed loan relating to the recourse, when the BPA is performed, if the new debt remission rules apply, the deemed loan will be treated by both

the guarantor and the debtor as being repaid to the extent that the liquidation causes a shortfall and the debtor will not have any BPA income.

Dividend changes

30. Section CD 5 provides that a dividend includes a loan remission where the shareholder is the debtor.

31. Effective from the 2008-09 income year, except if a contrary tax position has already been take for the 2015-16 or earlier income years, s. CD 5(2) has been amended so that a dividend will not arise if:

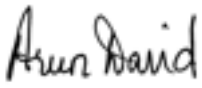
    (a) The obligation the debtor is released from is an amount of debt to which s. EW 46C(3) applies; and

    (b) At the time the debtor is released, the debtor is a company that is a member of the same wholly-owned group as the creditor, and the debtor is described in section EW 46C(1)(a) or (b).

32. There appears to be an error in this amendment, as s. EW 46C(3) states that s. EW 46C does not apply if the creditor is non-resident and the debt has been previously held outside the wholly-owned group. The reference should be to a debt to which s. EW 46C(3) does *not* apply.

33. As noted in paragraph 17 of last week's *Weekly Comment***,** above, this exception will not apply if the debtor is not resident in New Zealand, such that a non-resident shareholder benefits. The debt remission will continue to result in a dividend in such circumstances.

34. Finally, s. CW 10(4), which provides that the wholly-owned group inter-corporate dividend exemption does not apply if the dividend arises from a remission of debt has been repealed as it is no longer relevant, given the changes to the debt remission rules.



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