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QWB0135: Income Tax: Scenarios on tax avoidance

Introduction

1 The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the draft Question We've Been Asked QWB0135: Income Tax: Scenarios on tax avoidance.

2 The Law Society would like to preface these comments by commending Inland Revenue for publishing its view on the application of the GAAR to specific common fact situations, and by encouraging Inland Revenue to become more active in this area.

3 Particularly when it identifies transactions which it believes large numbers of taxpayers may be engaging in and which may be subject to the GAAR, Inland Revenue has a responsibility to provide clear guidance and warning, so that the GAAR operates as a fence at the top of the cliff.

4 The Law Society expects that Inland Revenue will receive a number of comments on this item, expressing a range of views. While the process of dealing with those views may be somewhat challenging and time-consuming, the Law Society encourages Inland Revenue to engage with the submissions, and expresses its own willingness to discuss the matter further in the interests of producing correct, helpful and sensible guidance in this difficult area.

Comments

Scenario 1 – interest deductions where shareholder loans replaced

5 We suggest some minor changes in the attached mark-up of the Exposure Draft, but otherwise we agree with the analysis and conclusion in this scenario.

Scenario 2 – look-through company election

6 As with scenario 1, we have marked-up some minor suggested changes, but broadly agree with the analysis and conclusions. In addition, it seems to us that question 2 might provide a useful opportunity for a demonstration of the Commissioner's approach to reconstruction. Presumably the arrangement that would be treated as void is only the LTC election. The sale of the property and distribution of the proceeds in liquidation would not be affected. So, for example, any capital gain arising on the sale of the assets would be able to be distributed other than as a dividend.

7 Although it is not central to the conclusion, we do not agree with the statement in paragraph 36 that there is a divergence in question 2 between the arrangement as it appears and how it appears when viewed in a commercially and economically realistic way. The arrangement appears to be an LTC election by a company which is about to go into liquidation. That is exactly what it is commercially as well. The distinction in our view between the first and second questions is that in the second case, the LTC election is being used as an option to reduce the tax payable on the winding up of a company. That was not the purpose of the LTC regime. In the first case it is being used to achieve look through tax treatment for an on-going company.

8 We also do not agree with the statement in paragraph 36 that the arrangement in question 2 is artificial or contrived on the grounds that obtaining LTC status is an unnecessary step in achieving the winding up of the company, serving only to achieve that objective in the most tax-efficient manner.

9 The Supreme Court in *Ben Nevis* confirmed that taxpayers have a freedom to structure their transactions to their best tax advantage (at [111]). This freedom is subject to the requirement that these tax advantages are obtained in a manner that is within Parliament's contemplation. Artificiality and contrivance are hallmarks of arrangements that obtain tax advantages in a manner that is outside Parliament's contemplation.

10 To the extent that the Exposure Draft implies that seeking to obtain a tax advantage constitutes an artifice or a contrivance that an advantage so obtained is therefore outside Parliament's contemplation, it leaves no room for the qualified freedom of taxpayers identified in *Ben Nevis*. Rather, to the extent that artificiality must be identified in the arrangement, we locate it in the fact that the company does not continue to operate in any meaningful way as an LTC.

Scenario 3 – substituting debentures

11 We make our comments on scenario 3 under two headings:

- The Parliamentary purpose for the convertible note exclusion.
- Policy Advice comments.

Parliamentary purpose

12 In paragraph 52, the draft states that Parliament would expect the exclusion for convertible debentures from the operation of section FA 2(5) to operate only if the debentures have some prospect of changing the effective ownership of the company on conversion.

13 We can see no sensible basis for such an expectation.

14 A debenture will not be within section FA 2 unless it is pro rata with equity in some way. When a debenture which is pro rata with equity converts into shares there will often be no change in the effective ownership of the company. For example:

14.1 If the debentures convert upon the happening of a certain event or at a certain time, then the conversion will not change effective ownership, because all of the debentures will convert.

14.2 If the debentures are convertible at the option of the company, it could generally be expected to convert all of them, or at least a pro rata percentage from all shareholders, to avoid any suggestion of bias.

15 Only if the debentures are convertible at the option of the holders would it be likely or possible for the conversion to change percentage ownership.

16 So, from a commercial perspective, it seems quite wrong to us to say that Parliament would only have intended the convertible note exception to apply if there is a prospect of a change in effective ownership.

17 The situation is not analogous with *Alesco*, for the key reason that section FA 2(5) is premised on the convertible notes being held on a pro rata basis. There is no such premise in relation to an OCN.

18 Secondly, there is nothing at all artificial or contrived about a conversion option of the kind described in paragraph 43 third bullet point. A conversion of that kind can be commercially critical. Insolvent companies are not supposed to continue to trade. The directors face severe sanctions if they do continue to operate an insolvent company. The company may not be able to prepare accounts on a going concern basis.

19 Like other debt, shareholder debt is taken into account in determining solvency. If a company with shareholder debt is balance sheet insolvent, the conversion of shareholder debt into equity may return the company to solvency, so that it can continue to trade.

20 Thirdly, it is obvious that the exclusion from section FA 2(5) for convertible notes is anomalous. Convertibility into shares makes a debt instrument more like a share, not less, and therefore makes it more appropriate to re-characterise it as equity for tax purposes. The reason the exclusion is there has nothing to do with a Parliamentary expectation that the convertible notes "have some prospect of changing the effective ownership of the company on a conversion" (to quote paragraph 52 second bullet point). The exclusion for convertible notes is plainly no more than a relic of the pre-1987 legislative scheme, where convertible notes were re-characterised as equity pursuant to a different section with slightly different rules. It is:

20.1 unrealistic to suppose that the convertible note exclusion would exist otherwise; and

20.2 unnecessary and inappropriate to import into this example the rationale from the courts' decisions to apply section BG 1 to the convertible note in *Alesco*.

View of IR Policy

21 Also arguing against the inference as to the purpose of the convertible note exclusion is the fact that in suggesting section BG 1 could apply in this case, Inland Revenue is going against its own view of the law. In a Regulatory Impact Statement (RIS) dated 16 December 2013, Inland Revenue stated (at p4) that the policy rationale for excluding convertible notes from the substituting debenture rule expired with the introduction of the accrual rules. It went on to say that the continued existence of the exclusion is anomalous and counter-intuitive.

22 As is clear from the above, we agree with the comments in the RIS. It seems evident to us that that the Exposure Draft's effort to find a purpose for the exclusion, while no doubt well-intentioned, is misplaced and will lead only to error. The Exposure Draft should recognise that in some cases the law is defective, and to look for underlying meaning is futile and misguided.

23 Furthermore, when applying section BG 1, it seems to us very important that the Office of the Chief Tax Counsel (OCTC) is informed by Policy. While we understand that OCTC is the legal expert within Inland Revenue, when applying section BG 1 the importance of the policy perspective is greater than it is with any other section. It would be unfortunate for OCTC's examples on the application of section BG 1 to conflict with Policy's prior advice that the convertible note exclusion serves no useful purpose.

Impact of the above on application of section BG 1

24 The conclusion that the convertible note exclusion does not serve any discernible purpose means that there is very little scope for section BG 1 to apply to treat the issue of such a note as subject to section BG 1. If a note is convertible, it is not subject to section FA 2(5). It is not possible for the conversion feature to be challenged as outside Parliament's purpose or contemplation, because there is no discernible purpose or contemplation served by the exclusion.

Scenario 4 – Debt capitalisation

25 This is the most troubling of the four examples, for a number of reasons, which we set out briefly here and expand on below.

25.1 The analysis of the black letter position needs to be clarified.

25.2 The paragraphs applying section BG 1 give three different reasons for applying the section to this example, only one of which is relevant. The other two should be raised and dismissed.

25.3 The example does not recognise that in many situations the purpose of the recapitalisation will be to enable the company to continue to trade. Section BG 1 should not apply to create debt forgiveness income in that situation, either technically or as a matter of policy.

25.4 Even where the debtor company is not intended to continue to trade, in many cases the decision to undertake a debt recapitalisation should not be subject to section BG 1:

(a) Debt is often used as a more administratively simple funding mechanism than share issues, particularly in a wholly owned group. Recapitalisation in this case is simply putting the company in a position which it could have adopted earlier.

(b) Recapitalisation of a solvent company is such a commercially usual and obvious step to take that Parliament must have contemplated it, and have been happy with the tax consequences flowing from it.

(c) In the overwhelming majority of cases where the issuing company is not a qualifying company, even in the absence of a recapitalisation there will be no reportable debt forgiveness income, and no tax paid on any income that does arise.

Black law position

26 The example involves a subscription by Company D's shareholder for shares for $500, and a debt repayment of $700 by Company D to the shareholder, satisfied in part by way of set-off of the repayment amount against the amount due for the issue of the shares. Company D also uses its cash reserves to repay the balance of the shareholder loan.

27 Despite this description of the arrangement, at paragraph 65 the draft item states that the consideration paid by Company D to repay the loan is:

> *the sum of the cash consideration of $200 paid and the non-cash consideration of $500 provided by issuing shares to the shareholder*.

28 In our view this statement is much too compressed in relation to the "non-cash consideration", and needs to be expanded on. It seems that Inland Revenue is treating Company D as repaying the debt in part by issuing shares – that is the only explanation for the reference to "non-cash consideration". That treatment also seems to underpin the statements in paragraph 76. However:

28.1 That is not the legal form of the transaction. The legal form is that Company D is repaying the debt entirely in money, a part of which is set off against another monetary consideration owed to the Company. If this legal form is being disregarded without the application of section BG 1, that needs to be explained.

28.2 One possible explanation for disregarding the legal form is that the debt repayment and the share subscription are part of a wider financial arrangement. In our view this is a sufficiently important point that it needs to be explicitly addressed in the example. Is it appropriate to analyse the situation as involving a wider financial arrangement or not?

28.3 If the consideration provided by Company D is indeed the shares rather than the $500, why do the shares have a value of $500? Obviously that is the stated issue price. However, subpart EW has specific rules for the valuation of non-cash consideration. It is not obvious that applying these rules would result in a value for the shares of $500, though that might be the correct answer. While we understand that the example is primarily about section BG 1 rather than the financial arrangement rules, it is not possible to properly apply section BG 1 without a correct understanding of the underlying technical rules in the Act – a point that is made very clearly in the Interpretation Statement on BG 1.

Reasons given in QWBA for applying section BG 1

29 The analysis provides a number of possible reasons for applying section BG 1 to the transaction. They are:

29.1 There is no actual or economic cost to Company D in issuing the shares (paragraph 77).

29.2 The issue of the shares does not dilute the shareholder's interest in the Company (paragraph 78).

29.3 The shares have little value (paragraph 78 again).

30 In our view, only the third of these reasons is relevant, and the other two should be explicitly dismissed.

Invalid reasons

31 The irrelevance of the first two reasons can be demonstrated by supposing that company D were solvent, for example if it had cash of $1,200, and retained earnings of $400. In that case if it repaid the $700 debt by issuing shares for $500 and using $200 of cash:

31.1 it would still only have an economic cost (as that phrase is used in the example) of $200 for repaying $700 of debt;

31.2 it would have more shares on issue and the existing shareholder will simply own the increased number of shares.

32 Despite those facts, section BG 1 would (we believe) clearly not apply in Example 4 if Company D were solvent:

32.1 There is good case law authority in the context of solvent companies for the proposition that an issue of shares does give rise to a cost which is relevant for tax purposes.

32.2 If that were not the case, some aspects of the New Zealand tax system clearly would not achieve their intended aims.

33 The leading UK authority addressing the issue is the Court of Appeal decision in *Osborne.* That case involved the transfer of trading stock to a company for consideration consisting partly of cash and partly of shares. The Crown argued that the cost base for the stock was limited to the cash component of the consideration, on the basis that the "issue of the shares [had] not cost the [taxpayer] company anything". The Court of Appeal referred to the Crown's argument as a "remarkable contention" unsupported by authority and held that the cost base for the trading stock was the cash plus the par value of the shares issued in consideration for the transferred trading stock.

34 Independently of the case law position above, acceptance of Inland Revenue's conclusion that Company D suffers no cost would create significant (and likely unintended) uncertainty in relation to the operation of other regimes within the Income Tax Act 2007 which are based on notions of cost. A logical extrapolation of Inland Revenue's position is that depreciable property contributed by a parent to a subsidiary in exchange for shares would have no cost base for tax depreciation purposes. Likewise in terms of shares issued for trading stock in circumstances similar to those considered in *Osborne*.

35 In our view the real issue is the value of the shares in Company D. In the case of a truly insolvent company, the shares are worthless, and may be so regarded, in terms of:

35.1 the valuation provisions in the financial arrangement rules; or, failing that,

35.2 section BG 1.

In the case of a solvent company, the shares are not worthless, and so cannot and should not be valued at zero when Company D applies the BPA in relation to the debt, or in considering the possible application of section BG 1. It is also quite possible that even in the case of an insolvent company, the shares are worth a good deal, because the accounting conventions may not allow for the recognition of speculative or incomplete assets.

Reasons for not applying section BG 1

Recapitalisation may be incidental to a commercial objective

36 A critical omission from this last example is a more explicit recognition of the fact that debt recapitalisations of this kind may well be undertaken for the purpose simply of providing the company with a more secure capital base, from which it can continue to operate. For example, suppose that Company D is a start-up business of some kind which is in the course of developing some new business asset which it is not yet able to recognise in its accounts. Suppose it wants to raise some mezzanine debt finance. The proposed lender will only lend if the current shareholder debt is clearly subordinated to the proposed lender's claim. An obvious way to achieve this is for Company D to convert its shareholder debt into equity.

37 Applying section BG 1 in that case to deem Company D to have debt forgiveness income would create an undesirable and wholly inappropriate obstacle to the continuing operation of the Company.

Debt funding is often interchangeable with equity funding anyway

38 In many cases shareholder loans are a form of interim funding. Many start-up companies require regular injections of cash. It will often be unduly burdensome for the company and its directors to be going through the formalities required under the Companies Act for an issue of shares each time such an injection is made. It is much easier for the shareholder(s) to simply advance funds to the company as and when required, keeping a record of such advances as they are made. As and when required, these advances can be formalised by the issue of shares. Had they been so recognised in the first instance, there would be no debt forgiveness income.

39 The use of intra-group funding is obviously particularly common in the context of corporate groups. There is no significant business or commercial difference between intra-group loans and (for example) redeemable preference share funding, other than the fact the former require much less formality to both make and repay.

40 If the Commissioner were to seek to apply section BG 1 to debt recapitalisations occurring in a corporate group, whether of an on-going or dormant company, the only effect would be to force groups to undertake intra-group funding by way of RPS issuances, which would be cumbersome, expensive and inefficient.

Debt recapitalisations are sufficiently vanilla that Parliament must have contemplated them

41 In attempting to discern Parliament's purpose and contemplation for income tax legislation, one assumes that Parliament understands the commercial world in which that legislation operates. In enacting the debt remission income rule, Parliament can reasonably be taken to have recognised the possibility that a shareholder and corporate debtor might choose to undertake a debt recapitalisation. There is no reason to apply section BG 1 to overturn the black letter consequences of such a transaction.

Outside the qualifying company regime, the alternative to a debt recapitalisation will not produce an income tax liability

42 Lastly, it is important to understand that although the example in Scenario 4 involves a qualifying company, from a practical perspective there are many more non-qualifying companies in existence, and those responsible for the tax affairs of such companies will have a duty to attempt to discern, from the QWBA once finalised, what the Commissioner's view is of debt recapitalisations which they may undertake. Accordingly, it is important that the example explains how it might impact on non-qualifying companies.

43 In the kinds of situations with which the members of the Law Society's Tax Law Committee are familiar, where a corporate group has decided to get rid of an insolvent group company with shareholder debt, the most obvious choices (although there are others) are to:

43.1 undertake such steps as are necessary to get the company struck off the register without doing anything about the shareholder debt; or

43.2 undertake a debt recapitalisation and then undertake the steps necessary to get the company struck off the register.

44 In the former case, if debt remission income arises to the company at all, it will arise at the time the company is struck off the register and thus no longer owes the debt. It is likely that there is no entity which derives the income at that time, and accordingly no income. Even if there is income, it will not figure in a tax return, and there will be no-one who is liable for that tax.

45 Accordingly, undertaking a debt recapitalisation should not be tax avoidance. The debt recapitalisation does not change the incidence of or liability to income tax.

Conclusion

46 This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please do not hesitate to contact the committee convenor Neil Russ, through the committee secretary Rhyn Visser (04 463 2962 / rhyn.visser@lawsociety.org.nz).

Yours sincerely

Chris Moore
President

Encl:
Marked-up changes to Exposure Draft QWB0135