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QWB0136: Income Tax: Deductibility of Guarantee Payments

Introduction

- 1 The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the draft Questions We've Been Asked QWB1036: Income Tax: Deductibility of Guarantee Payments.

Comments

Capital limitation not relevant

- 2 The draft QWBA states that a guarantor will only be allowed a deduction for an amount paid out under a guarantee where the capital limitation does not apply to the guarantee. At paragraph 2 it is stated that this will "generally [be] where the guarantor is in the business of giving guarantees". At paragraph 12 the draft QWBA is more emphatic that "Unless the guarantor is carrying on a business of giving guarantees, the capital prohibition (sic) will apply to prevent a deduction to the guarantor".
- 3 The reasoning (as set out at paragraph 9) is that the guarantor will be entitled to the deduction if the general permission is satisfied, the capital limitation does not apply and then to the extent the deduction is not limited by section DB 15. The draft QWBA accepts that the general permission is satisfied where a guarantee fee is received (paragraph 11). However, in requiring the capital limitation also to be satisfied, the draft QWBA overlooks section DB 6(1) which permits a deduction for "interest" incurred, with section YA 1 defining "interest" (as used in section DB 6) to include expenditure incurred under the financial arrangement rules. Section DB 6(4) provides that section DB 6 overrides the capital limitation (although the general permission must still be satisfied and the other general limitations still apply). Accordingly, as the amount paid out under a guarantee is expenditure (as paragraph 32 of the draft QWBA acknowledges), the guarantee payment is deductible under section DB 6 regardless of whether the guarantor is or is not in the business of providing guarantees. Therefore this aspect of the commentary in the draft QWBA and Example 1 are incorrect.

Subsections DB 15(2)(b) and (c) do not apply where the parties have acted reasonably

- 4 At paragraph 21 it is said that subsections DB 15(2)(b) and (c) can apply, if it would have been possible for the surety or an associated person to influence a change or effect in relation to the occurrence or non-occurrence of an event that led to the expenditure or loss.
- 5 This statement could be given a very wide or a narrower reading. We think that a narrower reading is both preferred and, given the conclusion in Example 3 in the draft QWBA at paragraph 53,

intended. At paragraph 53 it is stated that "*Assuming that due care was taken in hiring and supervising the subcontractors, neither AGL nor an associate could have influenced the loss.*" This indicates that the subsections do not apply if the surety and any associated person have acted reasonably, even if the event may or may not have occurred had they made different decisions at an earlier point in time.

- 6 We suggest that the interpretation of paragraph 21 would be assisted by an additional statement such as "These sections do not impose strict liability on the surety or associated person. If they have acted with care and could not have reasonably foreseen the indirect consequences of earlier decisions, then the subsections will not apply."
- 7 Further, the statement at paragraph 21 and the conclusion in Example 3 appear inconsistent with the more trenchant statement in paragraph 22 that it is irrelevant whether the surety or associated person actually influenced the occurrence or non-occurrence of an event that caused the expenditure or loss. We suggest that paragraph 22 should be deleted from the QWBA.

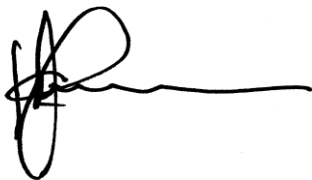
Other comments

- 8 Paragraph 26: the reference should be to the Judicature Act 1908.
- 9 Paragraph 50: the discussion should confirm what the outcome will be when the base price adjustment (BPA) is ultimately performed – namely no income or expenditure for FGL, whether the \$8,000 is recovered from FPL, or is written-off or becomes irrecoverable.

Conclusion

- 10 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 Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours sincerely

A handwritten signature in black ink, consisting of a large, stylized initial 'C' followed by a long horizontal line.

Chris Moore
President