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Debt remission
c/- Deputy Commissioner
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Officials' Issues Paper – Related Parties Debt Remission

Introduction

1. The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the officials' issues paper, *Related Parties Debt Remission* (Issues Paper). The Issues Paper proposes changes to the income tax treatment of certain related parties debt remission when the debtor and the creditor are either group companies, or when an owner or owners of a company or a partnership (including a limited partnership and a look-through company) remit debt.

2. The asymmetric income tax treatment of related parties debt remission is not a new issue. However, until recently, the issue did not arise in practice, as the insolvent debtor was recapitalised so that no debt remission arose. Inland Revenue's Office of the Chief Tax Counsel (OCTC) now considers that the capitalisation of debt is prima facie tax avoidance where there is no effective change in ownership of the debtor (whether or not the debtor is insolvent). See *Question We've Been Asked QB 15/01, Income tax: Tax Avoidance and Debt Capitalisation* (QB 15/01).

3. The Law Society disagrees with OCTC's views in QB 15/01 for the reasons set out in the Law Society's submission dated 4 July 2014 on *draft Question We've Been Asked QWB0135, Income Tax: Scenarios on tax avoidance* (QWB0135 submission). In particular, the Law Society considers that OCTC has used the wrong counterfactual in concluding that capitalising related party debt avoids remission income arising under the financial arrangements rules. As noted in paragraphs 42 to 45 of the QWB0135 submission, no related party remission income would arise if the insolvent company was not recapitalised, as that company would simply be struck off the register without the related party debt being remitted. Officials acknowledge that no remission income arises in these circumstances (paragraph 2.8 of the Issues Paper) and that, following the release of draft QWB0135, insolvent subsidiaries were either liquidated without related party debt being remitted or retained in their insolvent state (paragraph 2.20 of the Issues Paper).

4. Given OCTC's views on debt capitalisation and tax avoidance in QB 15/01, the Law Society appreciates officials' proactive approach in dealing with this issue and agrees with the core proposal to "switch off" debtor's remission income where the related party creditor is not entitled to a deduction for the resulting loss (paragraph 3.42 of the Issues Paper).

5. While the Law Society agrees with the general approach taken in the Issues Paper, the Law Society wishes to make submissions on: the application of the core proposal to certain related party situations where there is a change in the net wealth of the debtor; the application of the core proposal where the creditor is non-resident and the related party debtor is NZ resident; and the effective date of the core proposal.

Comments

Debtor's remission income should be 'switched off' where the creditors are the trustees of a complying trust and the debtor is a beneficiary of that trust

6. It is relatively common for a family trust to make loans, rather than distributions, to beneficiaries. Reasons include protecting trust assets from relationship property claims where financial assistance is provided to a 'second generation beneficiary' (e.g. the child of the settlor) and protecting trust assets from unforeseen creditors of the beneficiary.

7. Where the trustees of a trust make a loan to a beneficiary and that loan is subsequently forgiven, remission income arises under the financial arrangements rules. The natural love and affection exclusion (referred to in paragraph 2.11 of the Issues Paper) applies only where the creditor is a natural person, not the trustees of a trust (even if those trustees are natural persons).

8. Rather than forgiving debt owed by a beneficiary, the trustees of the trust would ordinarily make a capital distribution to the beneficiary on the understanding that the beneficiary would apply that distribution to repay the amount owed by the beneficiary to the trust. It is generally possible to make such a capital distribution from a complying trust (as distributions, other than distributions of beneficiary income, from a complying trust are not taxable), but not always possible where the trust is a foreign trust or a non-complying trust (as such distributions may be "taxable distributions" and the ordering rules prevent distributions being made from non-taxable sources in preference to taxable sources).

9. The Law Society is concerned that, in the light of the views expressed in QB 15/01, OCTC may consider that such an arrangement is tax avoidance, in that the debtor (the beneficiary) has not suffered an economic loss in repaying the debt and the creditor (the trust) has not received a net inflow of funds from the debt repayment.

10. The Law Society recommends that OCTC considers whether such an arrangement (i.e. making a capital distribution to a beneficiary to enable that beneficiary to repay a loan owed to the trust) is tax avoidance and, if OCTC concludes that such an arrangement is tax avoidance, then the core proposal set out in the Issues Paper is extended to the situation where the creditors are the trustees of a complying trust and the related debtor is a beneficiary of that trust.

Debtor's remission income should be 'switched off' where the creditor is non-resident and the related party debtor is NZ resident

11. The Issues Paper (paragraphs 1.10 and 3.33) states that the use of related party inbound debt (i.e. where the owner/creditor is non-resident and the debtor is NZ resident) is a key BEPS (base erosion and profit shifting) concern, and that continuing to tax related party debt remission for inbound investment may dissuade non-residents from over-gearing their NZ-based investments. Against this, officials accept that the non-resident owner's economic wealth does not change when it remits debt owed by the related NZ resident debtor (as in the domestic context) and that the NZ tax base may, in fact, be better off, not worse off, by not impeding the capitalisation of an inbound debt investment (paragraph 3.34 of the Issues Paper).

12. Officials seem to be concerned about examples it says the Commissioner has encountered where a company has been geared "so that it has not been able to pay the interest owed" (paragraph 3.36 of the Issues Paper). The language used implies that over-gearing is deliberate, rather than the consequence of, for example, poorer than expected trading. Officials suggest that taxing related party inbound debt capitalisation may dissuade such "excessive gearing" (which presumably is, nevertheless, within the limits prescribed by the thin capitalisation rules and compliant with the transfer pricing rules). On the other hand, officials acknowledge that taxing related party inbound debt capitalisation could equally dissuade non-residents from responsibly reducing debt levels.

13. The Law Society's view is that it is inappropriate to tax the capitalisation of related party inbound debt where the corporate group is endeavouring to act responsibly and commercially by reducing interest-bearing debt levels to ensure there is no impairment or insolvency, particularly in situations where the debtor has not traded as well as anticipated. The Law Society understands that this is the usual situation where debt capitalisation is contemplated. The Commissioner's approach would otherwise put the tax consequences as a driver of transactions, rather than as an outcome following normal commercial behaviour.

14. The Law Society does not consider that different rules should apply to the capitalisation (or remission) of related party debt where the creditor/owner is non-resident. The thin capitalisation and transfer pricing rules should stand alone and it is not principled to use the debt remission rules to buttress them. Officials should ensure that the financial arrangements rules apply in a principled way and are not used to address extraneous concerns.

15. If officials wish to deter deliberate "excessive gearing" by overseas investors, there are better avenues to consider, such as making targeted amendments to the thin capitalisation or transfer pricing rules, or aligning interest deductions on such debt with the obligation to account for NRWT.

Core proposal should apply from the commencement date of the financial arrangements rules

16. The Government has agreed, subject to confirmation after consultation, that the core proposal (that debtor's remission income is "switched off" where the related party creditor is not entitled to a deduction for the resulting loss and there is no change in the wealth of the creditor as a result of the debt remission or debt capitalisation) will apply from the commencement of the 2006/2007 tax year (paragraph 1.8 of the Issues Paper).

17. Despite officials' assurances that, pending the outcome of the policy process, Inland Revenue will not devote resources to determine whether there is any debt remission income arising from

arrangements covered by the core proposal (paragraph 1.9 of the Issues Paper), there have been instances where Inland Revenue has alleged tax avoidance in respect of debt capitalisation arrangements implemented before the 2006/2007 tax year.

18. The Law Society understands that Inland Revenue is of the view that the statutory time bar does not apply in situations where the "omitted income" arises as a consequence of a proposed exercise of the Commissioner's reconstruction powers under the anti-avoidance provisions (citing *O'Neil v C of IR* (2001) 20 NZTC 17,051 (PC) as authority for this).

19. In light of the above, and given the views expressed in QB 15/01, enacting the core proposal from the commencement of the 2006/2007 tax year will not deal with the asymmetry arising in respect of debt capitalisation arrangements entered into prior to that date. Accordingly, the Law Society recommends that the core proposal applies from the commencement date of the financial arrangements rules, and that corresponding amendments are made to the Income Tax Act 2004, the Income Tax Act 1994 and the Income Tax Act 1976.

Conclusion

20. 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 faithfully

Chris Moore
President