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KPMG welcomes debt capitalisation tax proposal

KPMG welcomes the confirmation that shareholders can convert debt to equity funding for insolvent companies.

This will provide business with a simple route to rationalise group structures without unwarranted tax effects.

The Government today released an Officials' Issues Paper on the tax treatment of debt capitalisations. The Issues Paper is available here.

A "debt capitalisation" arrangement is where a shareholder converts debt to equity. These arrangements are common place to support insolvent companies or entities facing liquidity issues.

Debt capitalisations were raised as a potential tax avoidance concern by Inland Revenue in a draft Question We've Been Asked ("QWBA") item released in June last year. Inland Revenue concluded that capitalising debt unacceptably avoided debt remission income, which would arise if the loan is forgiven. (You can read our taxmail on the draft QWBA item here.)

This conclusion challenged the commonly accepted way of managing the debt remission income problem and created uncertainty for past conversions and prevented future conversions.

In response to the outpouring of concern about Inland Revenue's draft tax avoidance conclusion, and its correctness, by KPMG and others, the finalised QWBA omitted the debt capitalisation scenario, pending consideration of a possible policy solution by Government.

Proposed legislative response

Under the proposal, no debt remission income will arise to the debtor, where a debt remission or capitalisation occurs:

- Within a wholly-owned group of companies, where the companies are within the New Zealand tax base (i.e. New Zealand tax resident or subject to the Controlled Foreign Company rules).
- Between a corporate debtor and a non-corporate (i.e. individual or trust) NZ shareholder who wholly owns the company.
- Between a corporate debtor and New Zealand shareholder creditors, if the debt is capitalised/remitted on a pro-rata basis (i.e. such that shareholders' proportionate ownership in the company is unchanged).
- Between a partnership debtor and its partner creditors, if the debt is capitalised/remitted on a pro-rata basis.

The Issues Paper proposes that any legislative change will have retrospective effect to the 2006-07 tax year. Inland Revenue will not devote its audit resources to investigating debt capitalisations, pending the outcome of the policy process.

KPMG comment

We welcome the release of the Issues Paper. Government and Officials are to be congratulated for developing a pragmatic legislative solution which will provide business with a simple route to rationalise group structures without unwarranted tax effects.

There are many wholly owned groups and family-owned entities that were affected by the draft QWBA view. (It is worth noting that the finalised QWBA did not retract the draft view.) These taxpayers have been unable to liquidate these insolvent companies because of the resulting tax uncertainty. The release of the debt capitalisation proposal by Officials, and Government's support for a law change, should largely end that uncertainty and allow these companies to be wound up, without any adverse tax consequences.

As expected, the focus of the issues paper is on debt remissions/capitalisations involving New Zealand wholly-owned groups and between NZ corporates/partnerships and their resident shareholders/partners. This should address the issue for the vast majority of affected taxpayers.

Non-resident inbound investment still under consideration

The more complicated issue of debt capitalisations involving non-resident shareholders of NZ companies is still being worked through. Officials are concerned about potential base erosion implications if the proposal for NZ wholly-owned groups is extended to foreign owned NZ groups.

Officials' concern is that allowing debt capitalisation will encourage debt loading up to the 60% level allowed for thin capitalisation purposes, even if the debt if unable to be serviced or repaid (as it could be capitalised, without any adverse tax consequences, to stay within the safe harbour). This concern is consistent with the view that interest deductions should be limited to third party debt, which is the approach taken by the OECD in its Base Erosion and Profit Shifting discussion document on interest deductions.

These concerns should be made explicit and the assumptions tested so that a proper policy solution can be determined. However, it is pleasing to see Officials acknowledge that, in principle, the same rules should apply to non-resident inbound investment.

We also welcome the 2006-07 retrospective application date and confirmation that, as a result, Inland Revenue will not be devoting audit resources to this issue. For those who have already undertaken debt conversions, they risked Inland Revenue audit activity and reassessments. The proposal means that risk and its associated costs are removed.

Debt capitalisation meets the "Parliamentary Contemplation" test

The proposal also highlights the highly uncommercial nature of Inland Revenue's draft QWBA view. Where a debt capitalisation occurs the shareholder has economically suffered a loss yet the application of the avoidance rules creates a tax liability. That such a conclusion can be put forward is an indictment of the state of New Zealand's tax avoidance law and of how it is being applied by Inland Revenue.

The "Parliamentary Contemplation" test in the tax avoidance rules is problematic and uncertain, in our view. In the draft QWBA, Inland Revenue determined that a theoretical or notional Parliament would have considered that a debt to equity conversion should not have the effect of preventing debt remission income from arising. It is interesting therefore to note that the Minister of Revenue, in his press release (and Cabinet as members of the real Parliament, in endorsing these changes), state that:

> *Tax law needs to provide certainty and <u>this proposal will address a situation where over-taxation is taking place</u>.*

[our emphasis]

Given this statement, it is not difficult to conclude that a real Parliament would not have contemplated that debt remission income (resulting in over-taxation) should arise in these circumstances. Accordingly, steps taken to prevent this over-taxation should have been accepted by Inland Revenue as within Parliament's contemplation.

We are reinforced in our view by the Issues Paper stating, at paragraph 1.13, that *"…the core proposal has no fiscal cost as debt remission income in the past did not arise because taxpayers used debt capitalisation instead"*. This means that the application of the general anti-avoidance rule was not factored into revenue forecasts. This is consistent with the position that debt conversion was an acknowledged and acceptable means of ensuring that over-taxation did not occur. It was contemplated as a matter of tax policy.

Inland Revenue's draft view has resulted in considerable uncertainty for taxpayers and advisers, with tax policy and legislative resources having to be unnecessarily deployed. Inland Revenue should apply the lessons from this process to its approach to determining what Parliament contemplated in future.

Further information

Submissions on the Issues Paper are due by 14 April. We strongly encourage those affected to make their views known.

If you would like to discuss this taxmail in greater detail, please contact your regular KPMG advisor or:

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