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Debt capitalisation II - Inland Revenue finalises its view

KPMG welcomed the release of a proposal last week, to change the law, to address Inland Revenue's concerns with debt capitalisations. The law change will have retrospective effect but it is not expected to be enacted until next year.

In the meantime, Inland Revenue's concerns with debt capitalisations, outlined in a draft Questions We've Been Asked item released last year, have now been confirmed in a finalised statement (available here).

While the proposed law change is a pragmatic response, companies will still have to deal with a potential tax liability for any issue of shares, including debt capitalisations for solvent companies and share based payments within wholly-owned groups.

Inland Revenue's confirmed view

Inland Revenue's view is that the anti-avoidance provisions could potentially apply where a shareholder capitalises a loan made to a wholly-owned company. This view applies whether or not the company is solvent (and potentially impacts any issue of shares within a wholly-owned group). However, Inland Revenue has confirmed that it will not audit scenarios which are covered by the proposed law change.

KPMG comment

We remain unconvinced by Inland Revenue's answer. In essence, we consider that Parliament would have contemplated that a share issue provides consideration in a wholly-owned company scenario. This is a basic construct of company and income tax law and should be given effect when assessing the effect of an issue of shares. Inland Revenue's analysis does not do so.

Financial reporting impact

Inland Revenue's finalised view creates a potential tax liability for financial reporting purposes. Companies will be required to focus on any issue of shares within a group, not simply those associated with insolvent companies, to confirm that a tax liability does not need to be recognised.

The relevant financial reporting test is the probability of the effect of current law, taking into account the view of a Revenue Authority and case law, creating a tax liability.

Inland Revenue's view is there is a tax liability on debt capitalisations. This must be considered and dealt with if it is material for financial reporting purposes. That will require a reasoned conclusion that Inland Revenue's finalised view is incorrect.

Unfortunately, the reasoning cannot rely on the proposed law change until the legislation is substantially enacted. It is not available as evidence that there is no current liability. Therefore, the counter arguments will need to focus on the commercial and economic effects of a debt capitalisation and whether the tax effects are merely incidental.

Inland Revenue's statement that certain scenarios will not be audited is a factor that can be taken into account. However, as the Commissioner can change her position (albeit unlikely given the proposed law change) and the statement does not cover all potentially affected scenarios, this fact alone will not be sufficient to dismiss the potential liability.

Companies will also need to consider whether their judgment on Inland Revenue's position needs to be disclosed in their financial statements.

Action points

The release of Inland Revenue's final view means that companies will need to rebut this view for financial reporting purposes.

The finalised view also expands the possible "at risk" scenarios. Those with situations which are not within the proposed law change are still at risk of Inland Revenue audit and dispute. They should respond to the recent issues paper with submissions to ensure that their fact pattern is covered by the proposed retrospective law change.

Further information and assistance

If you would like to discuss this issue in greater detail, or need assistance with rebutting Inland Revenue's position on debt capitalisations, please contact your regular KPMG advisor or:

John Cantin
Partner – Tax
Wellington
Phone: +64 4 816 4518
E-mail: jfcantin@kpmg.co.nz

Darshana Elwela
National Tax Director
Auckland
Phone: +64 9 367 5940
E-mail: delwela@kpmg.co.nz

Graeme Edwards
National Managing Partner - Audit
Wellington
Phone: +64 4 8164552
E-mail: gdedwards@kpmg.co.nz

kpmg.com/nz

twitter.com/KPMGNZ