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Deputy Commissioner
Policy and Strategy
Inland Revenue Department
P O Box 2198
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Our ref 150414KPMGsubDebtRemission

29 April 2015

Dear Sir

KPMG submission on "Related parties debt remission"

KPMG is pleased to make a submission on the above Officials issues paper which responds to the Commissioner's finalised QB 15/01 on debt capitalisation and tax avoidance.

General submissions

We strongly support the proposal to ensure that a related party debt remission does not give rise to debt remission income. This will, if the circumstances in which it applies are appropriately specified, provide a welcome and quick resolution to the problem raised by QB 15/01. We acknowledge that a law change provides the most pragmatic approach to resolving the problem.

We continue to have concerns that the limited solution proposed does not provide a comprehensive solution to the question of the tax treatment of debt remission income. For scenarios outside the proposed solution, there will be a greater risk that QB 15/01 can be successfully applied by the Commissioner. A more extensive solution is required.

We see the specific legislative response proposed as an interim measure. A longer term (but still relatively short) process is required to resolve these problems.

Detailed submissions

Our detailed comments are attached and in summary:

Section 1

- Record our view that the Commissioner's QB 15/01 is incorrect but supports a legislative response due to the time that a dispute would take to resolve the position through the Courts.

Section 2 and Appendix 1

- Consider available responses to QB 15/01 to make our assumptions and approach more transparent;

Section 3

- Outlines our understanding of the proposal including its scope, our expectation that consideration will be deemed to be provided on a debt remission and notes our concern that scenarios outside the scope of the proposal will be at greater risk of QB 15/01 applying;

Section 4

- Submits that the scope should be extended to cross-border transactions which is consistent with the BEPS project but notes that this may create deductible/non-(withholding) taxable results and therefore proposes the deeming rule apply for the purposes of the Act;

Section 5

- Submits that the domestic rule should apply where there is an asymmetry in the tax treatment of a debt remission.

Section 6

- Submits for a broad rule which applies when there is no deduction for the lender while acknowledging that this is in the absence of detailed information on the original avoidance concerns that led to the introduction of the debt remission rules. This is consistent with New Zealand's lack of a capital gains tax;

Section 7

- Addresses the specific technical questions that have been asked including a reason why all debt parking scenarios should be included in the solution;

Section 8

- Considers an alternative approach of a specific consideration rule for debt capitalisation which does not apply for existing disputes or any rulings where the taxpayer applies them as an approach which allows debt remission income to be managed without debt remission income arising. However, this is not a preferred option as it does not deal with non-company debt remissions;

Section 9

- Submits that whether the proposal, as modified in line with our submissions, or the submitted alternative is implemented, the need for the debt remission rule as a broad anti-avoidance rule should be reconsidered and replaced with targeted rules if the concerns remain valid.

Section 10

- The Commissioner's QB 15/01 operational position should be to apply the position prospectively only.

General comment

We appreciate that this question has been both controversial and difficult. Many taxpayers, especially those with experience of overseas tax systems, cannot see any justification for the QB 15/01 conclusion or New Zealand's general approach. They express frustration with their inability to restructure companies in a manner which has been commercially accepted and practiced from before the advent of the financial arrangement rules. They incur costs in maintaining effectively dormant companies because the even low risk of a tax liability does not warrant a dispute with the Commissioner.

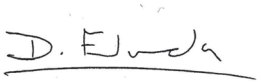
We therefore wish to acknowledge the Minister's willingness to have the matter accorded a high priority and the relative speed with which Officials have developed a solution which can be consulted on.

Further information

We would be pleased to discuss any aspect of our submission.

Please do not hesitate to contact us, (John Cantin on 04 816 4518 or Darshana Elwela on 09 367 594), if you would like to discuss this submission in greater detail.

Yours sincerely



John Cantin
Partner

Darshana Elwela
National Tax Director

DETAILED COMMENTS on Related Parties debt remission

1 Commissioner's finalised view on debt capitalisation

Incorrectness of the view

The Commissioner's QB 15/01 conclusion relies on a conclusion that Parliament did not contemplate that a debt capitalisation's effect would "avoid" the consequences of a debt remission. We continue to have significant concerns with the Commissioner's view.

The debt capitalisation approach to dealing with related party debt was well known by taxpayers and Inland Revenue Policy. No policy concerns were ever raised and, anecdotally, debt capitalisation was encouraged as a solution to debt remission problems by Inland Revenue Policy.

This is because the debt remission rules were included to address avoidance concerns. It was considered difficult to draft an appropriate rule to address those concerns so a debt remission rule was included. The debt remission rules were not intended to apply when those avoidance concerns did not arise.

In our view, these factors and the additional submissions we made on the draft item, support the contrary conclusion that Parliament did in fact contemplate that debt capitalisation is not tax avoidance. We note the reasonableness of that conclusion can be confirmed by the Minister's announcement

Options to overturn the conclusion

However, in the absence of legislation, a taxpayer's only option to correct the Commissioner's view is to dispute the conclusion through the Courts. This is a solution with an unacceptably long time frame. Despite our view (and that of many others) of the incorrectness of the conclusion, this significant period of uncertainty will unnecessarily constrain commercial responses to dealing with related party debt.

Accordingly, we support a legislative response.

2 Potential responses to QB 15/01

We have attached as an appendix our summary of the potential responses to QB 15/01. This provides background to our more detailed submissions below and makes our approach and thinking more transparent.

3 The proposed solution

We understand that:

- the key principle is that the current asymmetric treatment of related-party debt remissions and capitalisations is an anomaly where there is no economic benefit to an owner; and
- the proposed solution is for remission income not to arise when a debt is remitted for certain ownership and entity scenarios.

Covered scenarios

The core proposal is that there should be no debt remission income when the debtor and creditor are both in the New Zealand tax base and are members of the same wholly-owned group of companies. The issues paper also proposes extending this treatment to debtors that are companies or partnerships, if all of the debt remitted is owed to shareholders or partners and if there would be no dilution in each shareholder or partner's ownership interest if the debt was capitalised instead.

Effect of the proposal

We are not certain but we assume that the proposal will be achieved by deeming consideration to be given and received for the purposes of the financial arrangement rules. Under this approach, no base price adjustment income will arise when the debt is remitted. We assume that this also means that the lender will not be entitled to any bad debt deduction.

The effect of the amendment for QB 15/01 would be that as no income arises under a debt remission, a debt capitalisation does not avoid any income so that section BG 1 cannot apply.

However, QB 15/01would not be addressed for those scenarios outside the scope of the proposal. Where debt is capitalised outside the narrow scope of the proposal, the Commissioner would be able to argue that parliament did not contemplate, in these scenarios, a debt capitalisation as a means to avoid the effect of the debt capitalisation rule. This would worsen the position for those in that scenario.

Support for proposal

We support the proposal but consider that it must be considerably extended.

4 Inbound debt capitalisation should also be within scope

The issues paper states that further policy work is underway on whether the proposed legislative solution should also apply to debt remissions/capitalisations by non-resident shareholders (i.e. "inbound debt capitalisations"). This is therefore outside the scope of the current proposal, with associated risks for taxpayers (see *Inland Revenue's operational approach*).

We understand that the issues paper does not include these scenarios due to concerns that the proposal would encourage "excessive deductions" against the tax base by non-resident investors. Although we acknowledge that the Government is entitled to consider these issues and that such consideration may lead to law changes, the debt remission issue is not an appropriate place to consider and deal with those concerns.

Extending the proposal is within current settings and consistent with the BEPS project

In our view, New Zealand's thin capitalisation and transfer pricing rules are correctly aimed at addressing those concerns. The ability to capitalise or remit the debt has not been a factor in foreign investors' debt funding (although it may have influenced the choice of debt instrument).

The Commissioner's incorrect conclusion in QB 15/01 should not be used as a means of buttressing these rules. To the extent there are concerns about over deductions, the primary thin capitalisation and transfer pricing rules are the appropriate place to address these concerns.

Further, these concerns are being addressed by the OECD's Base Erosion and Profit Shifting project. Its objective is to have tax paid where there is economic activity and to avoid both double taxation and double non-taxation. To the extent there are over deduction concerns, the OECD actions are promoting an outcome that has higher equity and lower interest deductions in a high tax jurisdiction (and the reverse in low tax jurisdictions).

If the proposal does not extend to inbound debt scenarios, the Commissioner will be placing a further tax cost to achieving the desired outcome of less debt in New Zealand. Extending the proposal to inbound debt is consistent with the BEPS project.

Amendments to the proposal may be required if extended

We understand that the solution is to deem consideration for the purposes of the financial arrangement rules. The effect of this will be to preserve interest deductions for the New Zealand borrower without giving rise to a withholding tax liability if the debt is remitted. This is because the interest may not have been paid if it is simply (and correctly) accrued in terms of the instrument.

We assume that would be an unintended result.

The choices would therefore be:

- to deny the interest deduction; or
- to deem interest to be paid and withholding tax can therefore be paid.

We prefer the first option which could be achieved by deeming only the principal (including capitalised interest) amount to be paid. This would mean that the borrower would have base price adjustment income equal to the interest it has not paid.

If the borrower is to preserve its deduction, the debt would need to be capitalised rather than remitted and the interest would be paid and withholding tax would apply. We note that the policy objectives for this choice would need to be clearly articulated so that the Commissioner is not encouraged to apply section BG 1 to this method of preserving the borrower's interest deduction.

5 Domestic tax base scope for the proposal is too narrow

We believe the proposal should be wider.

The underlying principle is that there should be no adverse tax consequences if there is an asymmetry in result and no change, overall, in the ownership of the debtor or in the owners' net wealth. The latter results in a limitation of the proposal to wholly owned groups and pro rata scenarios.

We agree with the proposition that there should be no tax consequences if there is no change in economic situation or wellbeing. However, the limited proposal does not address the asymmetry

of treatment. As currently proposed, the solution will not be applicable if debt and equity are not issued pro-rata and/or where not all shareholders are creditors.

In these situations, where debt is converted to equity, regardless of the level of existing shareholding, there is no additional value created. The tax consequences should be neutral, as they were in the absence of the Commissioner's statement. Debt capitalisations in these circumstances do not challenge the asymmetry principle above. Therefore, the legislative response should be wider to encompass scenarios where the lender is not entitled to a deduction on the base price adjustment.

In the domestic context, we note that the deeming rules would mean that the borrower's deduction would be preserved while the lender would continue to have financial arrangements income. As consideration would be deemed paid, no deduction would arise on a BPA for the lender.

6 Broader response to the debt remission problem

In our view, a broader response needs consideration because any borrowing outside the scope of the legislated response will have a greater risk of the debt capitalisation anti-avoidance rule being applied to them. This is because the lack of legislative response is likely to be taken by the Commissioner as support for the view that Parliament did not intend debt remission income to be "avoided" by debt capitalisation for situations outside the scope of the legislated response.

The asymmetry debt remission problem applies for a wide range of circumstances. We consider that this asymmetry is inconsistent with New Zealand's general lack of a comprehensive capital gains tax. We also note that New Zealand's approach is generally inconsistent with the rest of the world.

To address the problem, we consider, in the absence of a clear view of the original avoidance concerns (but see section 9 below), that the problem could be broadly addressed by deeming no remission income for the principal amount remitted where the lender is not entitled to a deduction.

This would allow all associated person lending to be within the scope of this rule. It should only exclude lending by those in the business of lending which are within the New Zealand tax base. We acknowledge that at the margin there will be some lending where the borrower will be unsure whether a deduction is available. In those cases, a requirement that the parties agree the position which they consistently apply could be imposed.

7 Technical issues

We make the following comments in relation to the various technical issues in Chapter 4:

- ***Accrued interest*** – the issues paper seeks feedback on a rule to disallow a creditor a bad debt deduction for associated persons' interest receivable. (This would require the debtor and the creditor to have knowledge about the bad debt deduction, which the issues paper considers should be the case with a related-party debt remission or capitalisation.) Prima facie, denying a bad debt deduction to the creditor seems reasonable if the debtor does not have income arising and in fact its deduction is preserved. However, we believe this rule

should be limited to situations where the debtor can make use of their interest deductions, such as under section DB 31(5).

- ***Transitional rule*** – we are concerned about the potential complexity of any rule which attempts to claw pack previous bad debt deductions.
- ***Debt parking*** – we support excluding debt covered by the debt remission/capitalisation proposal from the debt parking rules.

  Further, if we have correctly stated the proposed solution, we consider that debt acquired from a third party can be within the scope of the proposed rules. Under the proposal, the effect of deemed consideration on remission of debt, is that the lender would have income equal to the difference between the face value of the debt and the acquisition price of the debt. The borrower would have no further income. This is the same result as if the debt was capitalised.

  We note that under the QB 15/01 view, the borrower would have tax avoidance income of the whole of the debt despite the lender also having income. For example, if an associated person acquired a $100 debt for $85, on a debt capitalisation, the lender would have $15 of income. Despite this, the QB 15/01 view would be that the borrower has no economic cost and has $100 of BG 1 taxable income.

  This is a further example of the incorrectness of the approach.
- ***Dividends*** – we support the extension of the dividend exemption to remissions of shareholder debt by a company.
- ***Amalgamations*** – we support consequential amendments to the amalgamation rules to make these consistent with the core proposal.

8 Alternative interim approach

As we have indicated at section 3 and in appendix 1, there are alternative approaches. The proposed solution has a number of problems. We consider an alternative.

Broad outline

An alternative approach would be to introduce a declaratory rule in the base price adjustment provisions to confirm that the issue of shares to satisfy a financial arrangement obligation is valuable and accepted consideration. The effect of such a rule would be to confirm that parliament contemplated that a debt capitalisation did not avoid the consequences of a debt remission.

It would also be unnecessary to legislate a rule to deem consideration to have been provided for other purposes of the Act. The QB 15/01 view makes it clear that the Commissioner considers a debt capitalisation does provide consideration in the absence of BG 1 applying. It would be surprising if the Commissioner considered there was tax avoidance if the result was that withholding tax and taxable income arises.

Limiting the application of the rule

We understand that such a provision could affect existing disputes and tax positions.

We note that the amendments to the non-disclosure right in the Tax Administration Act ((to make the right effective in a Court discovery) did not apply to existing disputes. This meant that a taxpayer could not use the fact of the amendment in a current dispute. An equivalent rule could be drafted for this alternative approach. However, a taxpayer should be able to use the provision if it was successful in its dispute and in any case to ensure that it did not have debt remission income if it subsequently capitalise the debt.

It is also possible that the Commissioner has issued rulings to taxpayers. Taxpayers should be able to continue to apply such rulings despite the amendment. We acknowledge that taxpayers would only do so if the ruling was favourable to their position. We consider that this is an appropriate outcome as the Commissioner has issued any such rulings in the knowledge of the outcome. The Commissioner had alternative, sound and non-frivolous policy reasons for reaching a different conclusion. Applying such a rule will encourage the Commissioner to consider alternative policy positions when she considers the application of section BG 1.

Debt remissions remain adversely affected

A concern with this approach is that a debt remission would still give rise to income. The current proposal removes that concern for those within its scope. It removes inadvertent debt remissions which occur mainly in a cross-border scenario (when the home jurisdiction does not impose any tax cost on a debt remission) but also in domestic scenarios where advice is not taken before a capital restructure.

Non company scenarios remain adversely affected

For many businesses, a partnership or a trust is the chosen business structure. An approach which focuses only on debt capitalisations would mean that debt remissions with such entities would not have their debt remission problems solved. For the rule to be effective, the confirming consideration rule would need to be supplemented by rules which contemplated an economically equivalent rule for non-company structures. We have not in the time available developed such a rule but note that it is unlikely to be a simple rule.

Conclusion

We have tested the proposal against an alternative. Although the alternative can be made to work for company debt capitalisation, it does not solve the problem for a number of scenarios which the proposal does cover. In the absence to a solution to these scenarios under the alternative approach, the current proposal with a wide application is a better solution.

9 The core question of debt remission

In our view, QB 15/01 by raising the debt remission problem, means that a broader solution is required. With both the proposals (original modified as submitted or the alternative approach), the broader question of the correct tax treatment of debt remission income remains.

The debt remission rule is an avoidance rule. The original avoidance concerns are difficult to discern but we understand that the concerns were to do with loss generation and trading.

Since 1986, there have been many and substantial amendments to the Act to protect the tax base. It is not clear whether those amendments have removed or reduced those concerns. (It would however be surprising if those amendments had not reduced those concerns).

However, we now have nearly 30 years experience with the financial arrangement rules and with taxpayer's commercial and business models. It should therefore be possible to reconsider the concerns to test that they remain valid.

The Government should support the inclusion of debt remission on the work programme with a view to:

- Determining whether the avoidance concerns which led to the debt remission rule remain valid;
- Determining an appropriate treatment which deals with scenarios where those avoidance concerns do not arise; and
- Determining an appropriate targeted response to those avoidance concerns rather than a general rule which applies when those concerns do not apply.

10 Inland Revenue's operational approach

The treatment of inbound debt capitalisation is also relevant in the context of Inland Revenue's proposed operational approach for dealing with debt capitalisations already undertaken.

The issues paper states that Inland Revenue will not devote resources to determining whether debt remission income should arise in situations covered by the core legislative proposal. While this is a welcome clarification, as the current proposal excludes inbound debt capitalisations, technically these are still at risk of Inland Revenue audit. As the Commissioner's view is that debt capitalisations generally comprise tax avoidance (and this will presumably not change if inbound debt capitalisations are outside scope), there is no limitation on Inland Revenue re-assessing past inbound debt capitalisations. This creates significant historic risk for taxpayers.

As detailed in paragraph 2.19 of the issues paper, debt capitalisation have been a common debt management tool for many years and largely unchallenged until the release of the Commissioner's draft view in June 2014. Prior to this, there was no published Inland Revenue view on debt capitalisations, to suggest these may be tax avoidance.

If inbound debt capitalisations (and/or certain non-wholly-owned NZ debt capitalisations scenarios) are not within scope of the legislative solution, at a minimum, Inland Revenue should not be able to apply section BG 1 to transactions undertaken before the release of the Commissioner's draft statement. This is necessary to preserve equity and certainty for taxpayers.

Appendix 1

Issue	Option	Comment
Section BG 1 applies to a debt capitalisation as Parliament did not contemplate that it could be used to "avoid" debt remission income	Test Parliamentary contemplation in Court (as Inland Revenue has not accepted taxpayer arguments to the contrary, it is assumed that this is the only way that Inland Revenue would accept the incorrectness of its view)	Probably 10+ years solution unless a declaratory judgement on QB 15/01 can be obtained
	Amend section BG 1	Unlikely to be accepted by Government or Officials due to the risk that it "weakens" the current Inland Revenue favourable court decisions
Capitalisation is not within Parliament's contemplation	Amendment to ensure it is clear that Parliament contemplated a debt capitalisation so an avoidance conclusion cannot be drawn	Officials' have concerns that this will impact on certain litigation but it should be possible to draft application date in such a way that existing disputed transactions and rulings are not affected This does not address the common overseas approach of remitting debt or non-company situations
Remission creates income	Limited (tied to relationship between the parties) retrospective amendment to deem no remission income (unclear from the issues paper whether deems consideration or not, assumed that it will)	Officials preferred route Risk that the line drawn is, for taxpayers, too narrow (e.g. excludes cross-border) and, for fiscal position, too wide

	Broader (i.e. not tied to relationship between the parties) removal of remission income: • General amendment; • For principal only (allows remission of income consequences to flow); and/or • Only where the lender is not entitled to a deduction for its loss. Remission of interest would still be income.	Slows down the correction of the capitalisation issue as potentially a more significant piece of work • Unspecified original "avoidance" concerns might be opened up so defining and addressing these would be a key requirement; • Focusing on principal only means that amounts which have given rise to deductions (and losses) are clawed back by a more limited remission rule; • This addresses the problem where there is an asymmetry in treatment so third party financial institution borrowing would be the likely only scenario where debt remission income arises.