KPMG

TaxMail

4 September 2015

Regular commentary from our experts on topical tax issues

Issue 2

Positive debt capitalisation change announced

Snapshot

Cabinet has approved a proposal to ensure there are no adverse tax consequences where shareholder debt is forgiven or converted to equity (i.e. debt remissions and capitalisations). The rule will apply within the same wholly-owned group or where there is a pro-rata remission or debt capitalisation (i.e. no dilution in ownership or change in each owner's proportionate ownership).

Importantly, the announcement confirms that the rule will also apply where the lender is a non-resident. This was "still to be decided" in earlier consultation.

We welcome confirmation that inbound debt remissions and debt capitalisations will not be treated any differently. As the technical analysis notes, a different outcome would produce arbitrary results.

The Government expects to introduce legislation early next year. On current timetables, that means the legislation will be enacted sometime between September and November 2016. The proposal is to have retrospective application to the 2007-08 income year to safeguard taxpayers' historic positions.

We welcome confirmation that legislation to be introduced in early 2016 will comprehensively address the uncertainty created by Inland Revenue's view that debt capitalisations are tax avoidance

However, this does highlight the absurdity of this situation, which has required significant work by one area of Inland Revenue to fix a problem created by another part, not to mention the waste of taxpayer resources

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What has changed from the earlier proposal?

The original proposal was discussed in our February taxmail. In summary, the Government is proposing a legislative fix to Inland Revenue's view that companies which issue shares to repay debt owed to shareholders are avoiding tax.

The "core proposal"

The core proposal is largely unchanged from February. Cabinet has agreed there should be no debt remission income for the debtor when the debtor and lender are in the New Zealand tax base, which includes controlled foreign companies, and:

- they are members of the same wholly-owned group of companies; or
- the debtor is a company or partnership and:
  - all of the relevant debt is owed to shareholders or partners in the debtor; and
  - if the debt remitted was instead capitalised, there would be no dilution of ownership of the debtor following the remission and all owners' proportionate ownership of the debtor is unchanged. (This effectively requires the debt to be remitted or capitalised pro-rata to ownership.)

Inbound debt capitalisations and remissions

This is the key change. The original proposal discussed, but did not conclude on, the appropriate tax treatment when the owner/lender is a non-resident. The announcement confirms that the core proposal will also be extended to situations where the lender is a non-resident and the debtor a New Zealand resident.

Other clarifications

The announcement also clarifies that:

- The proposal will apply where the debt is advanced by a relative of the shareholder or owner.
- Nominal shareholdings can be ignored when measuring ownership for the purposes of the proposal.
- The debt will be deemed to have been repaid in full (including unpaid interest) for the purposes of the financial arrangements and other rules. This mirrors the current position where a debt is forgiven for "natural love and affection".

Application date

The proposal will have retrospective application to the start of the 2007-08 income year. However, Government is still undecided on whether this should be by backdating the proposal or grand parenting past returns and applying the proposal on a go forward basis.

Who's impacted?

The announcement should be welcomed by taxpayers who have undertaken, or are looking to undertake, debt capitalisations to clean up balance sheets. Non-resident owned groups will also be covered by the proposal, including for historic debt capitalisations.

Our view

We welcome the Minister of Revenue's announcement. It is a practical and more efficient way to resolve the uncertainty created by Inland Revenue's technical view.

However, this does highlight the absurdity of this situation. It has required significant work by one area of Inland Revenue to fix a problem created by another part.

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Significant resources have been wasted by Government and taxpayers and their advisors to get to a position which should have been clear from the outset.

We strongly agree with the extension of the core proposal to New Zealand entities owned by non-residents. The February consultation's suggested reasons to exclude non-resident owned groups were to buttress other rules, such as thin capitalisation and transfer pricing. There was no reasonable policy justification for taking a different approach. We therefore welcome the acknowledgement that excluding inbound debt capitalisations and remissions would have produced arbitrary results.

Note, however, that the thin capitalisation and transfer pricing concerns are likely to be considered as part of the Government's base erosion and profit shifting work. This, in our view, is the appropriate place to consider the "correct" level of interest deductions.

As a practical matter, we assume Inland Revenue's operational approach (as outlined in paragraph 1.9 of the February issues paper) will be updated to include inbound debt capitalisations, to ensure the Commissioner will not be devoting resources to enforcing her current view. A public confirmation of this would be helpful, given the timeline for the amending legislation.

The proposal covers wholly-owned and pro-rata debt remissions and cancellations. There will be no legislative protection for non pro-rata debt capitalisations. This might be the next area of uncertainty.

The Government and Tax Policy Officials have provided a reasonable level of comfort to assuage taxpayers' concerns. They should be commended for this.

For further information

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