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WEEKLY COMMENT: FRIDAY 20 OCTOBER 2017

1. The *Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017* (“the Closely Held Companies Act”) received the Royal assent on 30 March 2017. There are a number of changes affecting various parts of the Income Tax Act 2007 and the Goods and Services tax Act 1985.
2. This week I complete looking at the changes affecting look-through companies (“LTCs”). In the following weeks, I look at the qualifying companies continuity of ownership requirement, and other changes affecting closely held companies generally.

Self-remission of LTC debts

3. New rules relating to the tax treatment of debts that are “self-remitted” apply for income years beginning on or after 1 April 2011.
4. New s. DB 11(1B) permits a deduction for “self-remission” as follows:
“A person who has a negative base price adjustment under section EW 31(4) for a financial arrangement is allowed a deduction for an amount of the negative base price adjustment up to the maximum of their amount of *self-remission* for the financial arrangement.” (emphasis added)
5. To briefly recap, when a financial arrangement terminates under the rules in s. EW 29, a base price adjustment (“BPA”) must be calculated using the formula in s. EW 31. That formula commences by deducting what is paid by the person (which, in the case of a creditor would be the sum advanced and, in the case of a debtor of an unpaid debt, zero), from what is paid to the person (which, in the case of a creditor would be zero and, in the case of the debtor, the amount advanced). This calculation- i.e. the BPA - would, therefore, end up being negative for an unpaid creditor.
6. A person with a with a negative BPA is allowed a deduction for interest under ss. DB 6 to DB 8, and under s. DB 11 if the rules permit.
7. However, a further item in the BPA formula would eliminate the negative result if the creditor has “remitted” the amount advanced – i.e. excused the debtor from repaying the amount.
8. In addition, if a financial arrangement is disposed of for a consideration less than market value due to a decline in the debtor’s creditworthiness or because the debtor’s obligations have been reduced or cancelled, a creditor is deemed to have been paid the market value under s. EW 39, thereby eliminating a negative consideration for the purposes of the BPA.

9. For the debtor, the BPA results in income if a debt is unpaid, as explained in paragraph 5 above. Where a LTC owner is both a creditor (due to having advanced an amount to the LTC) and a debtor (because of the attribution of the LTC's debt to the owner), the above rules result in an unfair amount of taxation. This is because the owner as debtor has income, whereas the owner as creditor is denied an equivalent deduction.
10. This is remedied under the new rules in s. DB 11(1B), s. EW 31(11) and s. EW 39(4). A deduction is permitted to the creditor/lender for "self-remission" by:
 - (a) Allowing a deduction for a negative BPA resulting from "self-remission" under s. DB 11(1B);
 - (b) Excluding "a remission that is self-remission" from being "remission" for the purposes of the add-back in the BPA formula under a replacement definition of "remission" in s. EW 31(11); and
 - (c) Subtracting the amount of "self-remission" from market value for the purposes of calculating the BPA upon disposal of a financial arrangement, under new s. EW 39(4).
11. For an interest-free loan in New Zealand currency repayable on demand, which would be an excepted financial for the creditor/lender under s. EW 5(10) and to which, therefore, the above amendments would not apply, an amendment to s. EW 8 allows "a person to treat as financial arrangements ... any excepted financial arrangement to which the person is a party that is described in s. EW 5(10)".

What is "self-remission"

12. Under a new definition in s. YA 1, "self-remission" means, for a person:
 - (a) For the purposes of the BPA formula in s. EW 31(11), a remission amount for a financial arrangement under which, and to the extent to which, because of the operation of s. HB 1 (the LTC rules) or s. HG 2 (the limited partnership rules), the person is also liable as debtor in their capacity of owner or partner;
 - (b) For the purposes of determining market value upon disposal of a financial arrangement under s. EW 39(4), the amount by which the consideration for the disposal of a financial arrangement is affected by a factor described in section EW 39(1)(d), to the extent to which:
 - (i) The disposal occurs upon cessation of a LTC or dissolution of a partnership under s. HB 4(3) or (6) or s. HG 4; and
 - (ii) Immediately before the disposal, the person is also liable as debtor in their capacity of owner or partner because of the operation of s. HB 1 or s. HG 2.
13. Paragraph (a) if the above definition means that a shareholder or partner of a LTC or partnership will have a negative base price adjustment in their capacity as a creditor that neutralises out any income attributed to them as debtor in their capacity as owner or partner.
14. An example is provided on page 43 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 ("the TIB Item") of a LTC with 2 owners with equal 50% ownership interests, Shareholder A, who has lent \$100 to the LTC, and Shareholder B who has not lent the LTC any money. Shareholder A subsequently remits the \$100 debt it owes to the LTC:

“As a result of the remission both Shareholder A and the LTC need to make a base price adjustment (BPA).

(a) LTC’s base price adjustment

- (i) The base price adjustment formula is:

Consideration in – consideration out – income + expenditure + amount remitted

- (ii) The LTC has received \$100 in consideration and as a result its BPA is a positive amount of \$100.
- (iii) This \$100 is attributed equally to the two shareholders under the LTC look through rules in section HB 1. As a result, Shareholder A has income of \$50 and Shareholder B has income of \$50.

(b) Shareholder A’s base price adjustment

- (i) Again, the base price adjustment formula is:

Consideration in – consideration out – income + expenditure + amount remitted

- (ii) Shareholder A has paid out consideration of \$100 and has made a debt remission of \$100. However, \$50 of this debt remission is a “self-remission” under the amendments to section EW 31 as they are also liable as a debtor in their capacity as an owner of a LTC.
- (iii) As a result, Shareholder A has a negative base price adjustment of \$50.
- (iv) Shareholder A is entitled to a deduction for this negative base price adjustment under section DB 11(1B) up to the amount of the self-remission (\$50).
- (v) As a result, Shareholder A has income of \$50 attributed from the LTC and a deduction of \$50 and as a result has no net income from the remission. Shareholder B has income of \$50 attributed from the LTC.”

15. An example is provided on page 44 of the TIB Item of how the amendment allowing subtraction of the amount of “self-remission” from market value for the purposes of calculating the BPA upon disposal of a financial arrangement, under new s. EW 39(4) will work. It is noted on page 43 of the TIB Item that for a LTC, this can occur upon permanent cessation, capital reduction, or revocation of LTC status. For partnerships this can occur on sale of partnership interests by a partner or upon dissolution of a partnership:

A LTC is 50 percent owned by two shareholders – Shareholder A and Shareholder B. Shareholder A lends \$100 to the LTC.

The LTC becomes insolvent and cannot repay its debts. As part of a restructure the shareholders decide to convert the LTC to an ordinary company and as a result a base price adjustment is required for both the LTC and Shareholder A.

(a) Base price adjustment for LTC

Similar to the previous example, the LTC has income of \$100 which is attributed equally to Shareholder A and Shareholder B.

(b) Base price adjustment for Shareholder A

- (i) As previously noted, the BPA formula is:

Consideration in – consideration out – income + expenditure + amount remitted

- (ii) Under the old s. EW 39, Shareholder A would be treated as having been paid the full market value of the \$100 debt as if the LTC was not insolvent.
- (iii) Under the amendment to s. EW 39, Shareholder A may subtract the amount of “self-remission” from this market value. As a result, shareholder A is treated as having been paid \$50 for the debt.
- (iv) As a result, Shareholder A has a negative base price adjustment of \$50, which offsets the \$50 of remission income so that its net income is \$0.

- (c) **Shareholder B** on the other hand has income of \$50 from its share of the remission income.

Amendment to ensure LTC owners are taxed on LTC debts forgiven by third parties

16. Section HB 4 contains the general provisions relating to disposals of LTCs. A new s. HB 4(7) provides that the market value of an owner’s interest in a financial arrangement as debtor must take into account the amount of any adjustment for credit impairment.

17. It is stated on page 44 of the TIB Item that this ensures the debt remission rules work as intended so that when a debtor sells their interest in a financial arrangement that they will not be able to repay in full, they are treated the same as if the amount they are unable to repay was remitted. The new rule is explained on page 44 of the TIB Item as follows:

“Under the new rules, debtors will not need to rely on information from the creditor to determine the amount of credit impairment. Instead, the debtors will need to make a fair and reasonable estimate of the credit impairment based on the information they have available.

To determine the credit impairment, the key question to ask is “if the LTC was sold or liquidated, how much of the debt would be repaid to the creditor?” In most cases, determining this would involve looking at the balance sheet of the LTC to determine the net assets of the LTC.”

18. An example is also provided on page 44 of the TIB Item as follows:

“Tara sets up a LTC to hold a rental investment property. The LTC gets a mortgage of \$500,000 to finance the purchase of the property. The LTC has no insurance for the property.

Due to flooding, the rental property declines in value to \$300,000. The LTC also has \$50,000 in cash reserves. The only liability of the LTC is the mortgage which still has \$500,000 outstanding.

Tara decides to liquidate the LTC. In determining the market value of the mortgage, Tara must ask “if the LTC was sold or liquidated, how much of the debt would be repaid to the creditor?” As the LTC has \$350,000 in assets and no other liabilities other than the

mortgage, the answer to this question is \$350,000. When making the base price adjustment, this is the value of the arrangement for the LTC to use.”

19. This rule applies from 1 April 2011 (i.e. from the inception of the LTC tax regime). However, to avoid reopening past returns, any additional income and associated penalties and interest from those earlier years is brought to account in 2017-18 income returns by way of a new transitional rule in s. HZ 8.
20. The formula in s. HZ 8 requires taxpayers to revisit all past LTC disposals involving financial arrangements and apply the new rule to calculate revised income under a revised BPA. This is referred to as the “retrospective amount”.
21. This “retrospective amount” is then compared to the actual income returned on disposals of financial arrangements before the 2017-18 income year, referred to as “current income”.
22. The difference between the “retrospective amount” and the “current amount” will be income in the 2017-18 income year.



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