QUESTION WE'VE BEEN ASKED QB 14/11

INCOME TAX: SCENARIOS ON TAX AVOIDANCE

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about s BG 1.

Introduction

1. At a tax conference held in November 2013, there was a discussion of whether s BG 1 would apply to certain scenarios. This Question We've Been Asked (QWBA) considers three of the scenarios raised at the conference.

2. In the scenarios, the arrangements and the conclusions reached are framed broadly. As the objective is to consider the application of s BG 1, the analysis proceeds on the basis that the tax effects under the specific provisions of the Act are achieved as stated. However, it should not be presumed that this would always be the case. Also, additional relevant facts or variations to the stated facts might materially affect how the arrangement operates and a different outcome under s BG 1 might arise. Accordingly, the Commissioner's view as to whether s BG 1 applies must be understood in these terms.

3. Section BG 1 is only considered after determining whether other provisions of the Act apply or do not apply. Where it applies, s BG 1 voids a tax avoidance arrangement. Voiding an arrangement may or may not appropriately counteract the tax advantages arising under the arrangement. If not, the Commissioner is required to apply s GA 1 to ensure this outcome is achieved.

4. For a more comprehensive outline of the Commissioner's position on the law concerning tax avoidance in New Zealand, reference should be made to the Commissioner's Interpretation Statement: IS 13/01 *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (July 2013).

Scenario 1 — Interest deductions where shareholder loans replaced

Question

5. Whether s BG 1 applies to the following arrangement:

   - Company A is wholly owned by a family trust. The trust has advanced to the company $1m in shareholder loans. Company A has used the shareholder loans to finance its business operations for the purpose of deriving assessable income.
   - Company A borrows $1m from a third-party lender at arm's-length market interest rates to repay the shareholder loans to the trust.
   - The third-party borrowing by Company A is secured over the assets of the trust.
   - The trust uses the repaid funds to acquire a holiday home for use by the trust's beneficiaries.
   - For tax purposes, Company A deducts interest incurred on the loan from the third-party lender from its business income.

Answer

6. The Commissioner's view is that, without more, s BG 1 would not apply to this arrangement to deny Company A interest deductions under ss DB 6 or DB 7 for the interest incurred in respect of the loan from the third-party lender.

Explanation

7. Under this arrangement, Company A is replacing funds invested in its business operations by the trust with funds from the third-party lender. The objectives of the arrangement would seem to be to enable the trust to free up capital for reinvestment in other assets (the holiday home) while Company A maintains sufficient working capital in order to continue its business operations. The tax effect for Company A is that an interest deduction will be available under ss DA 1, DB 6 or DB 7 if previously the shareholder loan was interest free. Alternatively, a greater interest deduction will arise if the third-party loan bears a higher interest rate than the shareholder loan. No deduction would have been available had the trust borrowed directly to acquire the holiday home.

8. Parliament's purpose for the general deductibility provisions is to allow expenditure incurred in carrying on a business or deriving assessable income to be deductible as long as it was not capital or private or domestic expenditure. Private or domestic expenditure is expenditure referable to living as an individual member of society or to a household or family unit. Private or domestic expenditure is not usually referable to carrying on a business or deriving assessable income.

9. However, interest deductions are treated differently in several ways, including not being subject to the limitation on deducting capital expenditure provided in s DA 2(1). The limitation on deducting private or domestic expenditure provided in s DA 2(2) still applies. Generally, for interest deductions Parliament intended interest to be deductible where the loan capital relating to that interest is used in a business or in some other way in the production of assessable income (s DB 6, *Pacific Rendezvous Ltd v CIR* [1986] 2 NZLR 567 (CA)).

10. Parliament has also distinguished between some companies and other taxpayers in respect of interest deductions. Significantly, interest incurred by some companies is deductible under s DB 7 without the need to establish a nexus between the borrowing and carrying on a business or deriving assessable income. Section DB 7 does not apply to qualifying companies, nor does it apply to interest related to tax. There are other rules relating to non-resident companies, wholly-owned groups of companies and consolidated groups. By making this significant distinction, Parliament intended to clarify the interest deductibility rules applying to companies and to reduce compliance costs by simplifying those rules.

11. Where s DB 7 does not apply, the Commissioner's view is that the interest deductibility test is satisfied where borrowed funds are used to replace amounts invested in income-earning activities and to repay those amounts to the persons who invested them (*FCT v Roberts; FCT v Smith* 92 ATC 4380, see also BR Pub 10/19 *Interest Deductibility – Roberts and Smith – Borrowing to replace and repay amounts invested in an income earning activity or business*).

12. Accordingly, in an arrangement involving interest deductions, Parliament would expect to see, as matters of commercial and economic reality, borrowing by a company with attendant interest liabilities in circumstances where there is either compliance with s DB 7 or sufficient nexus or connection with a business or income-earning activity. Also, the interest deductions claimed should not be related to private or domestic expenditure.

13. Those requirements appear to be satisfied in the case of Company A. Company A has assumed a real liability in favour of the third-party lender and incurred interest as a matter of commercial and economic reality. Either Company A satisfies s DB 7 or the circumstances are such that the interest deductibility test is satisfied as the borrowed funds are used to replace amounts invested in the company's business.

14. This conclusion is not negated by the fact that the lending is secured over the assets of the trust. The deductibility of the interest turns on the question of the use of the funds borrowed, not the nature of any security given. Similarly, how the trust then uses the funds repaid does not have a bearing on this question. The Commissioner does not consider the circumstances are such that the interest could be characterised as private or domestic expenditure subject to the private limitation. Company A is not receiving any private or domestic benefit from the expenditure. As stated, the borrowed funds are replacing funds previously invested in the company's business operations. The commercial and economic reality is that the borrowed funds are used in the business and there is no private use of those funds.

15. Also, the types of factors mentioned by the court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115 (at [108]), such as artificiality or contrivance, do not appear to be present in this case. If those factors were present, they could indicate that the interest deductibility requirements are not met when the arrangement is viewed in a commercially and economically realistic way.

16. Accordingly, in the Commissioner's view, this arrangement is within Parliament's contemplation for the interest deductibility provisions. As such, it is not a tax avoidance arrangement as it does not have tax avoidance as a purpose or effect and s BG 1 would not apply.

NOTE: The Commissioner has considered a scenario dealing with interest deductions and avoidance in a previous QWBA: *QB 12/11: Income Tax – look-through companies, rental properties and avoidance*. In both that scenario and the scenario here, the Commissioner considers that the interest is deductible and s BG 1 does not apply. The scenario in *QB 12/11* differed in that it looked at the situation when an LTC borrows funds to buy a shareholder's private house, which the LTC then uses as a rental property. In comparison, the current scenario deals with the situation when a company that is not an LTC replaces a shareholder loan with debt. In both situations, the shareholders use the funds received from the company (in *QB 12/11* as sale proceeds and in this QWBA as return of their shareholder loan) to buy a house that is not used to derive assessable income.

The Commissioner has also considered a scenario dealing with loss attributing companies (LAQCs) and residential housing in Revenue Alert 07/01 *The sale of private homes to loss attributing qualifying companies to generate tax deductions* (October 2007). Revenue Alert 07/01 deals with the situation where a private home is sold to an LAQC and rented back by the former owners so that tax deductions can be claimed by the LAQC for outgoings that would otherwise be considered private expenditure. The Revenue Alert indicates that, generally, such an arrangement would be subject to s BG 1. A key difference between the scenario above and the Revenue Alert is that, even though rent is charged, if there were any borrowings, it would be difficult to conclude that they are used to earn income in the circumstances where the person lives in the home before and after the arrangement and the LAQC has no other income.

Scenario 2 – Look-through company election

Question 1

17. Whether s BG 1 applies to the following arrangement:

- Company B is owned equally by two family trusts. One of the trusts operates a farming business that is expected to incur losses for tax purposes in the future.
- Company B is operating a profitable business and has built up significant reserves (both tax paid and untaxed).
- The directors of Company B elect look-through company (LTC) status for the company and resolve to distribute all reserves as dividends once the LTC election takes effect.
- The existing reserves of Company B are distributed to the shareholders in the first year after attaining LTC status.

Answer – Question 1

18. The Commissioner's view is that s BG 1 would not apply to the arrangement.

Explanation – Question 1

19. The objectives of the arrangement would appear to be for Company B and its shareholders to avail themselves of options provided by the legislation. These are electing to operate as an LTC under the Act and distributing the company's reserves.

20. The relevant tax effects of the arrangement are:

- For the first year in which the company operates as an LTC, the shareholders will have income from Company B calculated according to s CB 32C (in addition to any look-through company income for that year under s CB 32B). Company B will cease to be an imputation credit account company. However, the shareholders will receive the benefit of the former balance of the company's imputation credit account as part of the calculation in s CB 32C. The result of that calculation in the first year is that the shareholders only pay tax on the company's existing unimputed reserves.
- In future years, as an LTC under subpart HB, the profits of Company B will no longer be taxed to the company at the company tax rate of 28%. Instead, they will be taxed to the trustee shareholders and taxed at the trustee rate of 33%, unless distributed to beneficiaries.
- If the profits of the company are distributed by the trustees to the beneficiaries, they will be taxed at the beneficiaries' marginal tax rates.
- As a result of the look-through nature of an LTC, in future income years, the trustee shareholder operating the farm could offset any farming losses against its share of any profits from Company B.
- Once operating as an LTC, distributions of company reserves, including the existing reserves, are not subject to further tax in the hands of the shareholders. An LTC is excluded from the definition of a "company" in the Act, which means that most of the rules that apply to companies, including the rules governing the taxation of dividends, do not apply to LTCs.

21. The particular avoidance issue in this scenario is whether the combined tax effect of the company's existing fully imputed reserves not being taxed at any more than the company tax rate where distributed to shareholders on a higher marginal tax rate, is within Parliament's contemplation.

22. The purpose of the LTC rules generally is to integrate a closely-held company's tax treatment with the tax treatment of its owners, similar to that of a partnership. In this they reflect the purpose of the qualifying company rules that they replaced. The qualifying company rules were introduced in 1992 after a review of the tax system by the Consultative Committee on the Taxation of Income from Capital (the Valabh Committee). The Valabh Committee noted that the shareholders of closely-held companies had "a practical choice of operating either as a sole proprietorship, a partnership or a trust" (*Taxation of Distributions from Companies* (November 1990) at paragraph 2.7.1).

23. Accordingly, LTCs are transparent for tax purposes. An LTC's income, expenses, tax credits, rebates, gains and losses are allocated to its owners. These items will generally be allocated to owners in proportion to the number of shares they have in the LTC. Any profit is taxed at the owner's marginal tax rate. The owner can use any losses against their other income, subject to the loss limitation rule that ensures the losses claimed reflect the level of the owner's economic loss in the LTC. The effect of the LTC rules is that shareholders can have the benefits of limited liability given by a company, as well as the ability to be taxed at the level of the owner.

24. Under the LTC regime company reserves may be distributed or drawn upon without the shareholders being taxed on the distribution. Parliament contemplated existing companies electing into the LTC regime, but the treatment of reserves under the LTC regime was not intended to apply to company reserves previously accumulated by existing companies. Because of this, a mechanism is needed to ensure tax is paid on existing company reserves when a company enters the regime. This mechanism is provided by s CB 32C.

25. Under s CB 32C the company's existing reserves are regarded as held by the shareholders in proportion to their look-through interest and each owner is deemed to have an amount of income arising on the first day of the income year the company becomes an LTC. In the first year after the election, the shareholders of existing companies pay tax at their marginal tax rate on a one-off basis on the company's unimputed reserves that existed at the time of the company becoming an LTC.

26. No further tax is paid by the shareholders on any subsequent distribution of reserves. This is regardless of whether any shareholders have a marginal tax rate greater than the company tax rate at the time. On the other hand, any shareholders with a marginal tax rate of less than the company tax rate will not receive any relief for tax paid by the company in excess of their marginal rate. Had the company not elected LTC status, this relief may have been provided to them in the form of excess imputation credits able to be carried forward to subsequent years and offset from future tax liabilities.

27. Effectively, this means that in the first year after the election the shareholders do not pay tax on existing fully imputed company reserves at their marginal tax rates. Had the arrangement not been entered into, the shareholders would have been required to pay tax at their marginal tax rates when these accumulated profits were distributed as dividends. The shareholders would have been required to pay further tax on fully imputed dividends because the distribution would not have then been from an LTC. As the shareholders in the arrangement are trustees, they would have had to have paid tax on any dividends that were trustee income at the higher trustee rate of 33%.

28. Parliament's purpose, as expressed elsewhere in the Act and in the way the LTC regime applies to new companies or existing companies after the initial year, shows that it generally intends profits earned through a company to be taxed at a shareholder's marginal tax rate. In this scenario, the avoidance issue is whether use of the election, the payment of tax under s CB 32C, and subsequent tax-free distributions is within Parliament's contemplation. In particular the issue is whether it is within, or contrary to, this more general purpose of Parliament for the taxation of shareholders.

29. The Commissioner's view is that Parliament has made an exception to its general approach of taxing company profits distributed to shareholders at the shareholders' marginal rates in the case of the first year following an existing company electing LTC status. Parliament may have made this exception in the case of an existing company electing LTC status for reasons such as reducing complexity and compliance costs. For this provision, considering the text and context of the legislation, it can be concluded that Parliament's purpose for shareholders of an existing company that is an LTC is for them to effectively pay a final tax at 28% on existing fully imputed company reserves so that ongoing distributions can be passed on to shareholders as they arise with no further tax effects.

30. In the Commissioner's view, the circumstances Parliament would expect to be present where an existing company elects to enter into the LTC regime are present in this arrangement when the arrangement is viewed as a whole. As matters of commercial and economic reality, there is a closely-held company that is carrying on a business that satisfies the requirements of entering into the LTC regime.

31. The types of factors mentioned by the court in *Ben Nevis* (at [108]), such as artificiality or contrivance, do not appear to be present in this case. If those factors were present, they could indicate the LTC regime requirements are not met when the arrangement is viewed in a commercially and economically realistic way. In reality, the arrangement consists of an election for a particular tax status by a closely-held company carrying on a business that is available under the Act followed by a distribution of company reserves.

32. The Commissioner considers that this arrangement is within Parliament's contemplation for the LTC regime. Without more, it would not seem to be a tax avoidance arrangement as it does not have tax avoidance as a purpose or effect and s BG 1 would not apply.

Question 2

33. Whether s BG 1 applies to the arrangement described in Question 1 of this scenario if:

- At the time of electing LTC status, Company B's directors also contracted to sell the company's business and decide to liquidate the company once the LTC election is effective and the sale has settled.
- The sale of the business is settled and the directors pass the resolution to liquidate the company. A liquidator is appointed who distributes surplus assets to shareholders and ensures the company is removed from the register of companies.

Answer – Question 2

34. The Commissioner considers that s BG 1 would potentially apply to the arrangement described in paragraph 33.

Explanation – Question 2

35. The arrangement for the purposes of s BG 1 in this variation of scenario 2 comprises the LTC election, sale of the business and the liquidation of Company B. It would appear the objective of this arrangement is to use the LTC regime to enhance the value obtained by the shareholders from winding up Company B. The relevant tax effect is that no dividends arise when the company winds up as an LTC. The other relevant tax effect is that the shareholders do not pay any further tax on the distribution of the company's fully imputed reserves before the company winds up. Accordingly, the relevant purposes of Parliament for this arrangement are derived from the dividend rules for a company that winds up and the LTC regime as a whole. In comparison to the original arrangement in Question 1, the different aspects of this arrangement of the business sale and wind-up bring a different perspective to discerning Parliament's relevant purposes.

36. An LTC is not treated as a "company" for the dividend rules so they do not apply to Company B when it is wound up. Parliament's purpose for companies that are winding up is for certain amounts to be taxable as dividends. However, Parliament contemplates that LTCs are not subject to these provisions. Accordingly, the election of Company B into the LTC regime circumvents Parliament's purpose for the application of the dividend rules to companies that are winding up. As will be discussed, despite the election, Company B is effectively not operating so the arrangement makes no other use of the LTC regime other than the initial election and treatment afforded an LTC upon wind-up. This is not consistent with Parliament's purposes for the dividend rules.

37. As discussed under Question 1, the purpose of the LTC rules is to provide transparent income tax treatment to closely-held companies operating as LTCs so they could be considered as viable alternative vehicles to partnerships and sole proprietorships for the conduct of businesses or income-producing activities. The rules provide for the treatment of an LTC's income, expenses, tax credits, rebates and losses, and distributions to shareholders. It is notable that a company only retains LTC status if it continues to meet the eligibility criteria. The benefits of the rules are intended to be accessed only by companies with certain characteristics and who continue to have those characteristics.

38. It is the Commissioner's view that Parliament's purpose for these rules is only given effect where a company is operating. That is, where the company has the prospect on an ongoing basis to employ capital to generate income, expenses, tax credits, rebates and losses. Also, several features of the rules anticipate the future tax treatment applicable to LTCs or their shareholders, for instance, the one-off payment of tax on reserves under s CB 32C and the one-off adjustment extinguishing losses that apply upon a company's entry to the regime. The rules ensure the benefits of the regime are limited to LTCs and their shareholders while an LTC is operating. It would follow that Parliament's purpose is that the entity is an operating one or has the prospect of operating when it enters and then uses the regime.

39. The Commissioner accepts arguments can be made to the contrary but considers that, on balance, all the above features of the LTC rules lead to a conclusion that Parliament's intention is for the effects of the regime to apply over time as LTCs continue to operate and carry out transactions with tax impacts. Therefore, the Commissioner's view is that a fact, feature or attribute Parliament would expect to see present in order to give effect to its purposes for the LTC regime is that the election and one-off payment of tax is available where the LTC is ongoing. It would be inconsistent with these purposes for an existing company to elect to become an LTC as part of the wind-up process just to take advantage of what

might be a more favourable tax treatment of distributions made to owners taxed at the highest marginal tax rate.

40. It is acknowledged that the regime contemplates an LTC liquidating in s HB 4(3). It also could be argued that the way LTC elections operate, particularly through s HB 13(4), quick "in-and-out" use of the regime is also contemplated and dealt with. However, the Commissioner views s HB 4(3) as a mechanical provision required to remove any doubt that liquidation is treated as a disposal of a shareholder's owner's interest. It should not be taken that this provision indicates Parliament's acceptance of an LTC's liquidation in the circumstances of Company B. Section HB 13(4) is part of provisions intended to protect the integrity of the regime. In the Commissioner's opinion, it does not indicate Parliament's comprehensive view of all time-related aspects of the regime.

41. In contrast to the arrangement under Question 1 of this scenario, there is effectively no operating company in this scenario, nor is there any prospect of the company operating. Instead, the objective of the arrangement is to wind up Company B. However, the manner by which the arrangement is carried out includes the step of obtaining LTC status, which is an unnecessary step in achieving that objective. It serves only to ensure the wind-up occurs in the most tax advantageous way. This would also be true even if there was an amount of time between the LTC election and the wind-up of the company. The key is whether the arrangement comprises both the wind-up of the company and an LTC election.

42. In Question 1 of this scenario the arrangement is within Parliament's purposes for the LTC regime and, as mentioned, the Commissioner would not seek to apply s BG 1 to that scenario. However, the contrary is the case in this variation of the scenario. In the Commissioner's view, it is strongly arguable that this arrangement is outside Parliament's contemplation for the dividend rules, the LTC regime and how the Act should apply to a company that is winding up. If the Act is being used or circumvented in a way that does not give effect to Parliament's purposes, even though the particular use (or non-application) is not explicitly dealt with in the legislation, s BG 1 will still apply. As such, the present arrangement is likely to be a tax avoidance arrangement as it has tax avoidance as a purpose or effect.

Merely Incidental test

43. The next step is to test whether the tax avoidance purpose or effect of the arrangement is "merely incidental" to a non-tax avoidance purpose or effect (referred to as the merely incidental test). For a full analysis of the merely incidental test see paragraphs 395 to 438 of IS 13/01.

44. Section BG 1 can only apply where an arrangement fails this test. The Commissioner's view is that the tax avoidance purpose or effect is unlikely to be merely incidental to another purpose or effect of the arrangement, such as the purpose or effect of ceasing the business operations and winding up the company. Unlike the arrangement in Question 1, electing LTC status was an unnecessary step inserted into the arrangement and the tax avoidance purpose or effect appears to have been pursued as a goal in its own right. As such, it does not seem to flow naturally from, or as a mere concomitant to, some other purpose or effect of the arrangement and the arrangement fails the merely incidental test.

Reconstruction

45. If s BG 1 is to apply to this scenario, consideration would have to be given to how the Commissioner would assess the tax liabilities of the relevant taxpayers. The effect of s BG 1 is that the whole arrangement is void as against the

Commissioner. In this scenario, voiding the whole arrangement would not appropriately counteract the tax advantages of the arrangement and may remove legitimate tax outcomes. In the Commissioner's opinion, an appropriate action would be for her to exercise her reconstructive power under s GA 1 to tax the sale and liquidation on the basis that Company B is not an LTC.

Scenario 3 —Substituting debentures

Introduction

46. This scenario involves an issue of debt by a company to its shareholders in a manner that potentially circumvents the substituting debenture rule in s FA 2(5).

47. The substituting debenture rule was originally enacted in 1940 as a specific anti-avoidance rule under very different tax policy settings. The repeal of the rule from 1 April 2015 has recently been enacted as part of Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Act 2014. Nevertheless, it is considered useful to comment on this scenario as it illustrates the application of s BG 1 where a provision's purpose has become less clear over time. In such situations, the Commissioner considers that the text of the provision, supported by the scheme of the Act, will generally be the key determinant of Parliament's purpose.

48. In a draft version of this QWBA circulated for public consultation, the Commissioner concluded that s BG 1 would potentially apply to the following scenario. The Commissioner now considers that s BG 1 would not apply, for the reasons set out below.

Question

49. Whether s BG 1 applies to the following arrangement:

- Company C is a joint venture company owned 50% by a New Zealand shareholder and 50% by an unassociated foreign shareholder.
- Company C is funded by a combination of ordinary shares, non-participating redeemable shares and interest-bearing shareholder debt (which is issued in proportion to the ordinary shares).
- The terms of the shareholder debt provide that on the occurrence of an insolvency-type event, the company has the option to convert the debt into shares having a net asset value equal to the face value of the loan.[1]

Answer

The following analysis focuses solely on the potential circumvention of the substituting debenture rule, and does not consider s BG 1 in relation to the financial arrangements rules or other tax implications of the arrangement.

50. The Commissioner's view is that s BG 1 would not apply to this arrangement.

51. Although not discussed below, the Commissioner considers that s BG 1 may potentially apply to alternative structures that have the effect of circumventing the substituting debenture rule, such as the use of "wrap-around" debt (and similar variants), or undocumented loans.

[1] The terms of the shareholder debt have been amended slightly from the scenario presented at the tax conference to avoid interpretive issues, as the purpose of the scenario is to consider the potential application of s BG 1.

Explanation

52. The objective of the arrangement appears to be for the shareholders to fund Company C with a combination of debt and equity. The relevant tax effects are that deductions for interest payments on the debt will not be restricted by s FA 2(5), and will therefore be deductible to Company C under s DB 7.

53. The text of s FA 2(5) suggests that Parliament's purpose is that interest payable under a debenture should be treated as a dividend and therefore non-deductible where the debenture is issued to a shareholder and the amount of the debenture is determined by reference, *inter alia,* to the number of shares in the company held by the shareholder. This will often be the case where debentures are issued in proportion to shareholdings. The text also suggests that Parliament's purpose is that the rule should not apply to a debenture that is a convertible note.

54. The legislative history indicates that the original purpose of the substituting debenture rule was to target transactions in which companies were swapping their ordinary equity for debt. However, that purpose has largely ceased to be relevant due to subsequent changes to the tax system. As a result, it is more difficult to determine a clear underlying purpose of the rule from its legislative history. Despite this, Parliament has retained the rule in its current form, and therefore it must be assumed to have a role to play.

55. It remains the case that the Act recognises a distinction between debt and equity. Interest payable in respect of debt is generally deductible, whereas distributions in the nature of dividends are not deductible. In certain instances, such as the current example, Parliament has legislated that particular debt instruments be recharacterised as equity (eg, substituting debentures, profit-related debentures, and stapled-debt securities), due to the equity-like features of those instruments.

56. The Commissioner considers that the text of the provision, supported by the scheme of the Act relating to debt and equity, is the key determinant of Parliament's purpose in this instance. Accordingly, Parliament's purpose in relation to the substituting debenture rule is that debt, where the amount is determined by reference to the number of shares in a company, should be reclassified as equity.

57. Convertible notes were originally excluded from the substituting debenture rule when a specific provision concerning the taxation of convertible notes was introduced into the Land and Income Tax Act 1954. The exclusion remains in s FA 2(5), as convertible notes are now intended to be dealt with under the financial arrangements rules. Accordingly, Parliament's purpose in this respect is that the tax treatment of convertible notes should be determined under the financial arrangements rules, rather than the notes being recharacterised as equity under the substituting debenture rule.

58. In an arrangement where s FA 2(5) does not apply, Parliament would expect to see either:

- debentures that as a matter of commercial and economic reality have not been issued by reference to the number of shares in the relevant company; or
- debentures that are genuinely convertible notes – eg, debentures that as a matter of commercial and economic reality:
  - are issued by a company;
  - relate to money lent to the company; and
  - are convertible – eg, they have:

- a realistic prospect of being converted; and
- some practical effect on conversion.

59. In the current instance, Company C has issued debentures to its shareholders in proportion to their shareholdings. This strongly suggests that the amount of the debentures has been determined by reference to the number of shares in Company C. Accordingly, the key issue is whether the debentures are genuinely convertible notes.

60. In the Commissioner's view, the debentures in this example are clearly issued by Company C in relation to money lent to it. Furthermore, the debentures appear to have a realistic prospect of being converted, as the trigger event (ie, an insolvency-type event) is a real possibility in the context of any corporate borrower. This is to be contrasted with a trigger event that may be so highly contingent that the debenture has little prospect of being converted as a matter of commercial and economic reality.

61. The Commissioner considers that Parliament would not have intended the convertible note exclusion in s FA 2(5) to apply in situations where conversion of the debentures would have no practical effect as a matter of commercial and economic reality. Both the High Court in *Alesco New Zealand Ltd v CIR* [2012] 2 NZLR 252 (HC) (at [112]) and the Court of Appeal in *Alesco New Zealand Ltd v CIR* [2013] NZCA 40 (CA) (at [11]) concluded that the convertibility feature of the notes in that arrangement had no practical effect. The High Court concluded that that aspect of the arrangement was artificial.

62. What the relevant practical effect contemplated by Parliament is may vary depending on the provision at issue. In the current instance, the Commissioner accepts that conversion of the debentures would have some practical effect, on the basis that:

- Company C will be able to enjoy both solvency and cash flow benefits on conversion without having recourse to its shareholders; and
- conversion is likely to affect its shareholders' priority on a liquidation as against third-party creditors.

63. On this basis, the Commissioner considers that what Parliament would expect to see in the arrangement is in fact present. It follows that the non-application of the substituting debenture rule would be within Parliament's purpose for that rule in this instance, and that the arrangement is not a tax avoidance arrangement in that respect.

References

Subject references:

Convertible notes
Dividends
Interest deductibility
Look-through company election
Merely incidental
Winding up
Reconstruction
Substituting debentures
Tax avoidance
Tax avoidance arrangement

Legislative references

Income Tax Act 2007: ss BG 1, CB 32B, CB 32C, DA 1, DA 2, DB 6, DB 7, FA 2(5), GA 1, subpart HB,

Case references

Alesco New Zealand Ltd v CIR [2012] 2 NZLR 252 (HC)
Alesco New Zealand Ltd v CIR [2013] NZCA 40 (CA)
Ben Nevis Forestry Ventures Ltd v CIR [2008] NZSC 115
FCT v Roberts; FCT v Smith 92 ATC 4380
Pacific Rendezvous Ltd v CIR [1986] 2 NZLR 567 (CA)

Related rulings/statements

BR Pub 10/19 *Interest Deductibility – Roberts and Smith – Borrowing to replace and repay amounts invested in an income earning activity or business*
IS 13/01 *Tax avoidance and the interpretation of sections BG 1 and GA 1 of the Income Tax Act 2007* (July 2013)
QB 12/11: *Income Tax – look-through companies, rental properties and avoidance*
Revenue Alert 07/01 *The sale of private homes to loss attributing qualifying companies to generate tax deductions* (October 2007)
Taxation of Distributions from Companies (November 1990, Consultative Committee on the Taxation of Income from Capital (Valabh Committee))