

## QUESTION WE'VE BEEN ASKED

**QB 20/02**

**Income tax – Natural love and affection exception to debt remission income for look-through company**

*This Question We've Been Asked is relevant to shareholders of a look-through company that has debt forgiven by a close friend or family member of the shareholders.*

### Key provision

Income Tax Act 2007,  
s EW 46C

### Question

**Does a look-through company derive debt remission income when a close friend or family member of the shareholders forgives a loan made to the look-through company?**

### Answer

**No. Section EW 46C prevents the look-through company from deriving debt remission income where all of the shareholders and the close friend or family member have natural love and affection for each other.<sup>1</sup>**

**The Commissioner will generally accept that the shareholders and the close friend or family member have natural love and affection for each other.**

### Key terms

Creditor – a person who lends money  
Debt – for example, a loan  
Debtor – a person who borrows money  
Look-through company – a type of company that is treated like a partnership for tax purposes

## Explanation

1. Legislative references are to the Income Tax Act 2007, unless otherwise stated.
2. When debt is forgiven by a creditor, the debtor may derive debt remission income under the financial arrangement's rules (s EW 31 (Base price adjustment formula)). Given the transparent nature of a look-through company (LTC), if debt remission income arises for an LTC it will be taxed in the LTC shareholder's hands (s HB 1).
3. Section EW 46C (Consideration when debt forgiven within economic group) provides for an exception that prevents certain debtors from deriving debt remission income. One situation s EW 46C can apply to is where a LTC derives debt remission income and the

<sup>1</sup> This is provided no other debt of the look-through company to which s EW 46C applies is forgiven at the same time.

creditor and the LTC's shareholders have natural love and affection for each other (s EW 46C(1)(e)).

4. A similar exception applies to partnerships (s EW 46C(1)(d)). While this QWBA does not consider the partnership exception, the conclusions reached in this QWBA are also relevant to partnerships where the creditor of the partnership and all of the partners have natural love and affection for each other.<sup>2</sup>

### Debts, debtors and creditors covered by the exception

5. Section EW 46C works by altering the usual position for "debt", "debtor" and "creditor". Relevant to this QWBA, debt, debtor and creditor will be covered by s EW 46C(1)(e) if debt is forgiven and:
  - the debtor is an LTC; and
  - the creditor has an effective look-through interest in the LTC.

### Single creditor group

6. The uncertainty addressed in this QWBA arises because the creditor is not the same person as the shareholders of the LTC. This means that, at first glance, the exception applying to debt owed by a creditor with an effective look-through interest in a LTC might not apply.
7. However, a separate rule modifies who the creditor is when applying the exception (s EW 46C(2)(b)). This rule works by treating a group of individuals (a single creditor group) as the creditor, if the following criteria are met:
  - The individuals in the group are either creditors or have interests (including an effective look-through interest) in the LTC or both.
  - Each individual in the group must have natural love and affection for each other individual in the group.
8. Assuming these criteria are met, the shareholders and creditor are together the "creditor" for the purposes of s EW 46C. As creditor, they are treated as holding the total debts and interests of the single creditor group. The deemed consideration rule described at [12] is then applied to the creditor and the LTC as debtor.

### Natural love and affection

9. For the single creditor group rule to apply, each individual in the group must have natural love and affection for each other individual in the group. This is the primary test. Natural love and affection is not defined in the Act. However, it will often arise in the context of domestic or family relationships.<sup>3</sup>
10. Natural love and affection will most commonly occur between immediate and extended family members, as well as de-facto partners.<sup>4</sup> It can also exist between close friends, such as life-long friends.<sup>5</sup>
11. The Commissioner will generally accept that there is natural love and affection between family members and close friends.

<sup>2</sup> This is provided no other debt of the partnership to which s EW 46C applies is forgiven at the same time.

<sup>3</sup> *Director of Public Prosecutions (Vic) v Le* [2007] HCA 52 at [48].

<sup>4</sup> See, for example, *PH v GH* [2013] NZFLR 387, *Taylor v Commissioner of Stamp Duties* [1924] NZLR 499, *Byrne v Bishop* [2001] 3 NZLR 780.

<sup>5</sup> See, for example, *Fisher v Kirby* [2013] NZFLR 463 and *Rumford Estate (Re)*, [1996] O.J. No.3484.

### Deemed consideration for debtor and creditor

12. The way the exception prevents debt remission income from arising is by deeming:
  - the debtor to have paid the amount of debt to the extent that the proportional debt ratio for the debt equals the proportional ownership ratio (s EW 46C(4)(b)); and
  - the creditor to have received payment for the amount of debt to the extent that the proportional debt ratio for the debt equals the proportional ownership ratio (s EW 46C(5)(b)).
13. In both cases, the deemed payment is made on the date the creditor forgives the debt.
14. The proportional debt ratio is the percentage the debt bears to the total amounts of debt owed by the LTC to which s EW 46C applies that are forgiven at the same time (s EW 46C(6)). The proportional ownership ratio is the creditor's percentage of the total effective look-through interests in the LTC (s EW 46C(6)).
15. In this QWBA, the debtor LTC is deemed to have paid the full amount of debt to the creditor. The creditor is deemed to have received payment for the full amount of debt from the LTC. This eliminates any debt remission income for the LTC. This is illustrated in the Example below.

### Example

#### LTC debt forgiven by a brother of the sole shareholder

Jo and James are siblings. Jo, a talented baker, incorporates a company, Jo's Baking Ltd, and becomes the company's sole shareholder. Jo elects for Jo's Baking Ltd to become a LTC.

James is keen to support Jo's business and loans \$50,000 to Jo's Baking Ltd.

Unfortunately, Jo's business is unsuccessful, and Jo's Baking Ltd cannot pay back James. James decides to forgive the debt. No other debt is owed by Jo's Baking Ltd and so no other debt to which s EW 46C applies is forgiven at the same time. Therefore, the proportional debt ratio is 100%.

Jo and James have natural love and affection for each other. This means, for s EW 46C purposes, Jo and James together are the "creditor" of the \$50,000 loan.

Jo and James together as the single creditor group hold 100% of the debt being forgiven. They also hold 100% of the effective look-through interest in Jo's Baking Ltd, so the proportional ownership ratio is 100%.

Section EW 46C will prevent any debt remission income arising for Jo's Baking Ltd (or Jo as shareholder). This is because s EW 46C(4) and (5) treats Jo's Baking Ltd as having paid back the \$50,000 loan to James at the time the debt is forgiven.

## References

### Subject references

Debt forgiveness  
Debt remission income  
Income tax  
Look-through company  
Natural love and affection

### Legislative references

Income Tax Act 2007, ss EW 31, EW 46C,  
HB 1, YA 1 ("look-through interest")

### Case references

*Byrne v Bishop* [2001] 3 NZLR 780  
*Director of Public Prosecutions (Vic) v Le*  
[2007] HCA 52  
*Fisher v Kirby* [2013] NZFLR 463  
*PH v GH* [2013] NZFLR 387  
*Rumford Estate (Re)*, [1996] O.J. No.3484  
*Taylor v Commissioner of Stamp Duties* [1924]  
NZLR 499