TECHNICAL DECISION SUMMARY > PRIVATE RULING

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKATAUNGA TŪMATAITI

Interest free loan and dividends

Decision date | Rā o te Whakatau: 8 May 2023

Issue date | Rā Tuku: 9 January 2024

TDS 24/01

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Subjects | Kaupapa

Income tax: capitalisation of company structure; interest free loan whether a dividend arises; withholding tax; tax avoidance.

Taxation laws | Ture tāke

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

Facts | Meka

1. This ruling involved the steps by which Company A is funded to enable its indirectly wholly owned subsidiary (Company B) to settle the sale and purchase of certain assets. It particularly includes the resulting interest free shareholder loan from Company C (a non-resident company) to Company A and the ongoing repayments of the loan.

Issues | Take

2. The main issues considered in this ruling were:
   - Whether the interest free loan gave rise to dividends to Company C from Company A;
   - Whether repayment of the interest free loan was subject to withholding;
   - Whether s BG 1 and GA 1 applies.

Decisions | Whakatau

3. The Tax Counsel Office (TCO) concluded:
   - The interest free loan from Company C to Company A does not give rise to a dividend from Company A to Company C under s CD 1 at any point in time, including as a result of the issue or repayment of the loan;
   - Company A is not required to withhold or pay an amount of tax under s RA 6 in relation to the interest free loan repayments made to Company C;
   - Sections BG 1 and GA 1 do not apply to negate or vary the above two tax outcomes.
4. The following condition was included:

- The only amounts payable under the interest free loan are the lending of the NZD principal by Company C as lender and the repayment of the NZD principal by Company A as borrower.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Whether the interest free loan gave rise to dividends (s CD 1)

5. Section CD 3 provides that ss CD 4 to CD 20 define what is a dividend for tax purposes.

6. The interest free loan provided by Company C would give rise to a dividend in accordance with s CD 4 if:

   - There was a "transfer of company value" from a "company" to a person.
   - The cause of the transfer was due to a "shareholding in the company".
   - None of the exclusions in ss CD 22 to CD 37 apply to the transfer.

7. Under s CD 5, a transfer of company value from a company to a person occurs when:

   - The company provides money or money's worth to the person; and
   - if the person provides any money or money's worth to the company under the same arrangement, the market value of what the company provides is more than the market value of what the person provides.

8. The following cashflow would arise on the interest free loan:

   - Company C would be providing principal to Company A.
   - Over time, Company A would repay the principal lent by Company C.

9. Accordingly, there would be no net cashflow under the interest free loan. However, there is a time value to money. The market value of what Company C would be providing to Company A, may be higher than the market value of what Company A would be providing in the future to Company C. That the provision of money (a loan) at below market interest rates can give rise to a dividend is illustrated by s CD 39 which applies to determine the amount of a dividend that arises because a company makes property available to a person. The deemed dividend is calculated by reference to a benchmark rate of interest.

10. However, any net transfer of value resulting from the interest free loan would arise to Company A (who would benefit from the below market interest rate), not Company C.

11. Therefore, Company C does not derive a dividend from making the interest free loan to Company A.

12. Given the conclusion in [11] above, TCO also considered the dividend implications for Company A.

13. A transfer of value by a company (Company C) to a person (Company A) will be "caused by" a shareholding relationship if the recipient (Company A) holds shares in the company (Company C), or is associated with a shareholder, and the company (Company C) makes the transfer because of that shareholding.

14. TCO determined that Company A did not hold shares in Company C but they were associated companies which meant the relevant shareholding relationship did exist.

15. TCO noted that s CD 4(1)(b), provided that a transfer of company value from a company to a person is a dividend if none of the exclusions in ss CD 22 to CD 37 applied.

16. It was found that the exemption in s CD 27(3) applied because three cumulative requirements were satisfied:

    - Company C, being the "first company", had a voting interest in Company A, being the "associated company": para (a)(i).
    - Company A, being the "associated company" did not have a voting interest in Company C, being the "first company": para (b).
    - No person, other than the parent company of Company C (Company D) had both a voting interest or market value interest in Company C (the "first company") and Company A (as the "associated company"). Company C is a wholly owned subsidiary of Company D. Company D and Company C were both not resident in New Zealand, and therefore Company D could have received the transfer of company value without it being assessable income or non-resident passive income.

17. Therefore, any transfer of company value from Company C to Company A would not be a dividend in accordance with s CD 27(3) and therefore would not give rise to a dividend under s CD 4.

Other rules

18. TCO also considered whether any of the following rules applied:

    - Financial arrangements rules
    - Recharacterisation provisions

- Hybrid mismatch rules
- Transfer pricing regime

19. TCO concluded that none of the above applied to affect the outcome.

Conclusion of issue 1

20. TCO concluded that the interest free loan from Company C to Company A did not give rise to a dividend from Company A to Company C under s CD 1 at any point in time, including as a result of the issue or repayment of the loan.

21. The conclusion was subject to the condition that the only amounts payable under the interest free loan were the lending of the NZD principal by Company C as lender and the repayment of the NZD principal by Company A as borrower.

Issue 2 | Take tuarua: Whether repayment of the interest free loan is subject to withholding (s RA 6)

22. Section RA 6 concerns withholding and payment obligations for passive income. Section RA 6(2) applies to a person who makes a payment of non-resident passive income under subpart RF. That person must withhold and pay tax to the Commissioner. This is relevant to the future interest free loan repayments which will be made by Company A to Company C.

23. Section RF 1(2) provides that the NRWT rules apply to a person who pays an amount of non-resident passive income. Section RF 2 defines "Non-resident passive income".

24. For the reasons discussed above, the interest free loan repayments made by Company A to Company C would not constitute a dividend (para (a) of s RF 2(1)) or interest (para (d)) paid to Company C.

25. The new interest free loan repayments do not constitute royalties (para (b)) or investment society dividends (para (c)).

26. Non-resident financial arrangement income (NRFAI) is defined in s RF 2C. In short, it is clear the interest free loan repayments would not constitute NRFAI (para (e)) as no interest is paid on the loan that would otherwise be subject to NRWT absent the NRFAI rules applying. Nor does any financial arrangement expenditure arise in respect of the interest free loan which means there is no deferral of NRWT.

27. Accordingly, the repayment of the interest free loan by Company A to Company C would not constitute a payment of non-resident passive income. Company A would not be required to withhold under s RA 6(2).

Conclusion of issue 2

28. Company A would not be required to withhold or pay an amount of tax under s RA 6 in relation to the interest free loan repayments made to Company C.

Issue 3 | Take tuatoru: Whether s BG 1 applies

29. Section BG 1(1) provides that a "tax avoidance arrangement" is void as against the Commissioner. The approach to s BG 1 was settled by the Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289, which has been followed in subsequent judicial decisions.

30. TCO's approach in making this decision is consistent with Interpretation Statement: IS 23/01 Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007 (3 February 2023) (IS 23/01). IS 23/01 will not be replicated in this TDS but in summary the steps are as follows:

- Understanding the legal form of the arrangement. This involves identifying and understanding the steps and transactions that make up the arrangement, the commercial or private purposes of the arrangement and the arrangement's tax effects.
- Determining whether the arrangement has a tax avoidance purpose or effect. This involves:
    - Identifying and understanding Parliament's purpose for the specific provisions that are used or circumvented by the arrangement.
    - Understanding the commercial and economic reality of the arrangement as a whole by using the factors identified by the courts.
    - Considering the implications of the preceding two steps and answering the ultimate question under the Parliamentary contemplation test: Does the arrangement, when viewed in a commercially and economically realistic way, make use of or circumvent the specific provisions in a manner consistent with Parliament's purpose?
- If the arrangement does have a tax avoidance purpose or effect, consider the merely incidental test.

31. Taking into account all of the relevant facts and circumstances (noting that as this is a summary it may not contain all the facts or assumptions relevant to the decision and, therefore, cannot be relied on) the TCO concluded as follows:

The arrangement

32. The arrangement is the steps by which Company A is capitalised and funded to enable its indirectly wholly owned subsidiary to settle the sale and purchase of certain assets. It particularly includes the resulting interest free shareholder loan to Company A and the ongoing repayments of the loan.

33. The tax effects regarding the interest free loan are:

- For the lender Company C:
  - No dividend income will arise under s CD 1.
  - No interest income will arise under s CC 4.
  - No financial arrangements income will arise under subpart EW.
  - No withholding will be required under s RA 6 from the repayments of the money lent by Company A.
- For the borrower Company A:
  - No dividend income will arise under s CD 1.
  - No financial arrangements income or deductible expenditure will arise under subpart EW, ss CC 3, DB 6 or DB 7.

34. The tax effects did not raise any s BG 1 concerns as the applicable legislative provisions were working as intended. There was no artificiality or circular money flows.

Parliamentary contemplation

35. It was clear from the Act that Parliament contemplated capital could be provided by way of interest free loans, made by a non-resident lender into New Zealand. It was also clear that the focus in the Act is on actual payments and net gains and losses, not the return of money lent. While various provisions are aimed at ensuring excessive interest deductions are not taken in New Zealand, there are no provisions seeking to create income where no amount is actually paid over and above the return of money lent.

36. Considering the above, TCO concluded that the repayment of money lent which does not give rise to income for the lender, did not raise any concerns from a tax avoidance perspective. The legislation was working as intended and the tax effects would be within Parliament's contemplation.

37. TCO discussed the distinction between debt and equity noting that for example, non-participating redeemable preference shares may be considered, in substance, to be

very similar to a loan. However, where capital is contributed whether by way of debt or equity, the return of that capital can be made tax free.

38. The main difference was about the relative ease of returning the original capital. From a company law perspective, it is easier to repay or restructure debt than it is return equity. From a tax perspective, the repayment of money lent is not taxable. The same is generally true for shares, but there are additional statutory requirements which revolve around the statutory notion of available subscribed capital which can be returned without being treated as a dividend.

39. TCO concluded that whether capital is contributed by way of debt or equity, Parliament contemplated that capital could be returned tax free as it is not a net gain that should be taxable as income. However, there are more restrictions when returning share capital.

Commercial and economic reality

40. There was nothing in the context of this Arrangement to suggest that, in commercial and economic reality, Company A should be treated as paying a net positive amount rather than returning the capital provided by way of the interest free loan.

Conclusion

41. Accordingly, TCO considered the provisions of the Act were being used and had the effect that Parliament intended. The above analysis indicated that it is likely that Parliament would consider that the Arrangement makes use of the relevant provisions in a manner that is consistent with Parliament's purpose for those provisions. Therefore, the Arrangement did not have a tax avoidance purpose or effect.