Regulatory Impact Statement

Review of the substituting debenture rule

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address concerns with the substituting debenture rule (the "rule"). The concerns have been raised largely by taxpayers and relate to uncertainty as to how and when the rule is intended to apply. The rule has the effect of recharacterising shareholders' debt in a company as equity in that company where the debt is issued to shareholders in the same proportion as the level of equity the shareholders have in the company. As a consequence, the company is denied a deduction for interest paid on the shareholder debt and the interest payments are treated as dividends paid to shareholders for tax purposes.

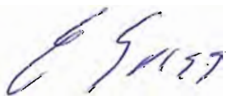
Concerns with the rule have been raised by a number of external parties. In response to these concerns, Inland Revenue has undertaken a full review of the legislative history of the rule (dating back to 1940).

Officials have concluded that the rule is redundant and therefore recommend its repeal. The rule does not fit within the current policy framework (in particular, our imputation system), it is causing problems in practice and there are more targeted rules governing the tax treatment of debt and equity. It is also imposing unnecessary compliance costs.

Officials considered anecdotal evidence of the problems the rule is causing and a selection of taxpayers' cases. Officials do not know how many taxpayers this measure will affect because there is no quantitative data available on these instruments. There should be no fiscal implications for the repeal of the rule because it is so easily circumvented and there is likely to be some non-compliance from lack of awareness of the rule. Other than this, there are no key gaps or dependencies, assumptions, significant constraints, caveats or uncertainties concerning the analysis.

There has been targeted consultation on this measure with a number of taxpayers and their advisors. There is widespread support for the repeal of the rule.

The recommended policy option will not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles. In fact, repeal of the rule should reduce compliance costs for businesses and administrative costs for the government. It should also enhance the simplicity, integrity and coherence of the tax system.



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STATUS QUO AND PROBLEM DEFINITION

Status quo

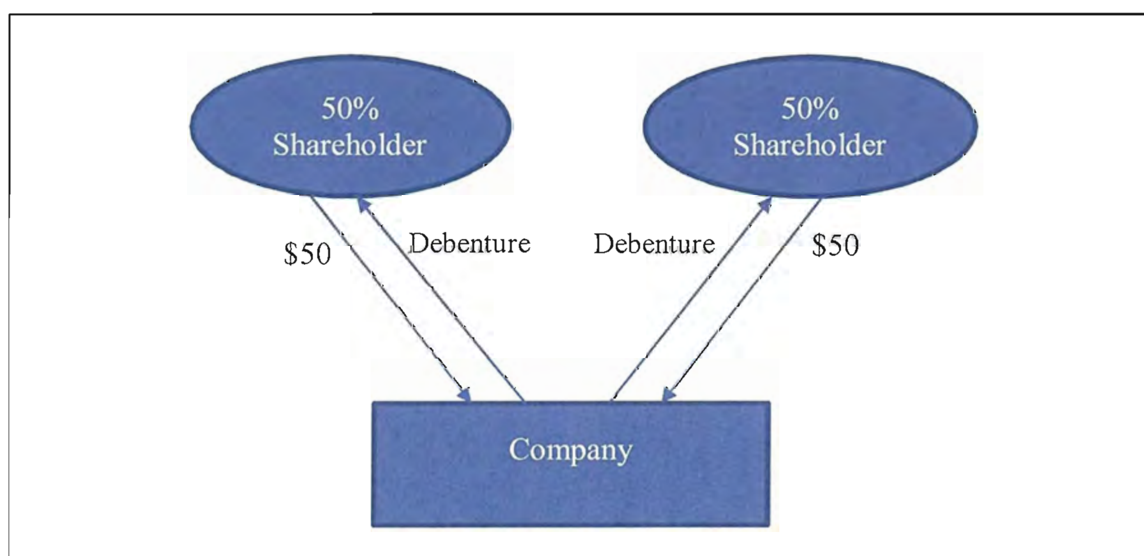
1. The Income Tax Act 2007 (Act) generally relies on the legal form of an investment (as debt or equity) to determine whether the returns are taxed in the shareholders' hands as dividends or interest and whether the company paying the return on the investment claims an interest deduction or not if it is a dividend. However, there are certain circumstances where it is appropriate or necessary for the tax treatment to depart from its legal form and rely instead on the economic substance of an arrangement. Rules that deem interest to be a dividend for tax purposes (or vice versa) are called 'recharacterisation' provisions.

2. The Act has three debt recharacterisation provisions (i.e. where investments that are in legal form debt are treated as equity for tax purposes):

- the substituting debenture rule;
- the profit-related debenture rule; and
- the stapled stock rule.

These were each introduced to protect the tax base in response to particular financing structures.

3. A number of tax commentators and advisers have raised concerns with the substituting debenture rule in section FA 2(5) of the Act.[1] This rule treats debt issued by a company to its shareholders by reference to their equity (most commonly debt issued in proportion to shares held) as equity for tax purposes. This means interest paid in respect of a substituting debenture is taxed as a dividend; it is non-deductible to the company and subject to imputation. A very basic example of this is shown below. In this example, the debentures would be recharacterised as shares in the company. Such debt is arguably economically equivalent to equity for the existing shareholders and this is, broadly speaking, the policy rationale for the recharacterisation.



[1] See for example, "The Substituting Debenture Rule - A compelling case for legislative euthanasia" by Casey Plunket and Kyle Rainsford in Taxation Today (April 2012) and "Shareholder loans rule shows age" by Greg Harris in the Waikato Times (1 July 2013).

Legislative history of the substituting debenture rule

4. The original substituting debenture rule was enacted in 1940 as an anti-avoidance measure to target transactions by companies who had converted (or planned to convert) some or all of their shares into debt. At this time, dividends were exempt and interest was taxable to the recipient, but it appears generally at a lower rate. It is also possible that the Government was concerned about the collection of tax from ultimate shareholders as the predecessor of resident withholding tax (RWT) was easily circumvented. Hansard is unclear on the exact nature of the 'avoidance' effected by the transactions.

5. In 1958 the dividend exemption was removed. This meant that dividends were subject to double tax, but interest was not (absent the substituting debenture rule). There was a clear tax incentive to structure investments as debt rather than equity, so the substituting debenture rule continued to serve an anti-avoidance purpose at this stage.

6. In 1960 an exemption from the substituting debenture rule was introduced for debts that were able to be converted into shares (referred to as "convertible notes"). This exemption was introduced because, at this point in time, convertible notes were covered by a separate provision in the Land and Income Tax Act 1954 that deemed them to be equity.

7. In 1987 specific financial arrangement rules were introduced (the effect of these rules is to require the spreading of income and expenditure under financial arrangements). At this time convertible notes were treated as debt again. The substituting debenture rule was not amended at this time. Arguably the rationale for the convertible note exclusion in the current substituting debenture rule ceased to exist at this stage.

8. Since the introduction of imputation in 1988, the original purpose of the substituting debenture rule has ceased to be relevant in many cases (as debt and equity returns are generally subject to the same tax treatment in the hands of New Zealand resident, taxpaying entities).

Problem definition

9. The root cause of the problems arising from the substituting debenture rule is that it does not fit comfortably within our current policy settings. There have been many changes to our tax system since the rule was introduced and given current tax settings (in particular the imputation regime), the rule no longer serves its original specific anti-avoidance purpose. There are a number of other, more targeted, rules that govern the tax treatment of debt and equity that have come in over time and overlap with this rule. This overlap is problematic as it reduces the coherence of our tax system.

10. In a practical sense, the provision in its current form has a number of flaws:

a) It applies too widely in some circumstances. Arguably any shareholder loan is caught. This is a trap for those not taking advice and it is triggered by fairly common, inoffensive company dealings. Taxpayers who inadvertently issue substituting debentures may have consequential problems with past tax years (for example, the company may have paid too little tax due by virtue of treating the interest as deductible, the incorrect amount of RWT may have been deducted by the company from the payments, no imputation credits would have been attached by the company to the 'dividend', and there may be penalties and use of money interest payable as a result of taking an incorrect tax position in past years).

b) It is too narrow in other circumstances, and is easily circumvented and manipulated. For example, the rule does not apply where the debt is in the form of a convertible

note[2] or where the loan is not made by the direct shareholder, but an indirect shareholder higher in the ownership chain. Taxpayers may also deliberately structure their funding as substituting debentures to take advantage of the equity recharacterisation. The ease with which the substituting debenture rule is manipulated may facilitate cross-border arbitrage, as taxpayers can effectively choose whether a debenture is treated as debt or equity for New Zealand tax purposes.

c) The policy rationale for excluding convertible notes from the ambit of the rule expired with the introduction of the accrual rules because at this time convertible notes were not covered by another section of the Income Tax Act 1976. The continued existence of the exclusion is anomalous and counterintuitive as a convertible note is perhaps one of the most equity-like debt instruments, yet is excluded from the recharacterisation rule.

d) The scope and the application of the rule are uncertain. This leads to increased compliance costs as taxpayers are inclined to seek advice (and even binding rulings[3]) on fairly straight forward transactions.

e) Furthermore, in light of the recent tax avoidance cases, taxpayers are becoming increasingly concerned about standard commercial transactions which seemingly circumvent the rule. It is difficult to determine whether Parliament's intention is frustrated when the policy issue the 1940 Parliament contemplated no longer exists given current policy settings.

11. Officials considered anecdotal evidence of the problems the rule is causing and a selection of taxpayers' cases. Officials do not know how many taxpayers this measure will affect because there is no quantitative data available on these instruments.

OBJECTIVES

12. The objectives of any amendments to the substituting debenture rule are to:

a) make it easier for businesses to operate and comply with their tax obligations, by ensuring that tax rules are clear, easily understood and certain;
b) reduce unnecessary compliance costs;
c) protect the integrity of the revenue base; and
d) promote the overall coherence of the tax system.

REGULATORY IMPACT ANALYSIS

13. The status quo and three other options for addressing this problem and achieving the objective are set out and analysed below. These options are:

a) maintain the status quo;
b) amend section FA 2(5) to fix its flaws;
c) repeal section FA 2(5) in its entirety (preferred option);
d) repeal section FA 2(5) and strengthen other rules.

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[2] Convertible notes are debt instruments that can be converted into shares at either option of the lender or the borrower.

[3] A taxpayer can apply to the Office of the Chief Tax Counsel within Inland Revenue for a binding legal opinion as to the tax treatment of a specific transaction. The Inland Revenue is bound by this view and therefore obtaining a binding ruling gives taxpayers a high degree of certainty when undertaking a transaction.

Option one – maintain the status quo

14. The status quo is currently causing problems in practice. The rule is unclear and difficult to apply. There is an element of uncertainty associated with structuring around the rule in the context of the general anti-avoidance rule (GAAR) in section BG 1 of the Act e.g. if a taxpayer issues a convertible note specifically to avoid the rule applying, is this tax avoidance under section BG 1?

15. This uncertainty results in increased compliance costs in the form of advisers' fees and (potentially) the cost of obtaining a binding ruling from the Inland Revenue.

16. Officials are aware that taxpayers are able to deliberately structure into the rule to take advantage of cross-border arbitrage opportunities. Use of a specific anti-avoidance rule in aggressive tax structures reduces the integrity of the New Zealand tax system and potentially erodes the revenue base.

17. The rule also does not fit well within the current tax policy framework, given that there is an imputation regime (which makes most domestic taxpayers indifferent between debt and equity) and a transfer pricing and thin capitalisation regime (which limits excess debt deduction in the international context). Therefore, the continuing existence of the rule reduces the overall coherence of the tax system.

18. Officials therefore believe that the status quo is not a viable option.

Option two – amend section FA 2(5) to fix flaws

19. There are a number of specific problems with the rule:

a) the carve-out for convertible notes does not make sense given current settings and it is easily used to the turn the rule on and off at will;

b) the rule only applies where a company issues debentures to its own shareholders, it does not apply where debentures are issued by a related party (e.g. a wholly-owned subsidiary of the company) or to a related party (e.g. a trust settled by a shareholder). It is easy enough for a company to incorporate a special purpose subsidiary to issue debentures to its indirect shareholders – so-called "wrap-around debt" or for a shareholder to settle a trust to hold the debentures. These structures achieve broadly the same economic outcome as direct lending, but in a way that circumvents the rule; and

c) the rule is too wide – it arguably applies any time a shareholder lends money to a company. This is relatively common place and not offensive in and of itself.

20. One option would be to amend the rule to address these concerns. While this would improve certainty (thus reducing compliance costs associated with the rule) and reduce the ability to manipulate the rules (thus increasing integrity), the fundamental question remains whether the rule itself is still appropriate given the current tax framework.

21. For the reasons outlined in paragraph 17, officials believe the rule does not fit well within our current tax system. Therefore, merely amending the drafting of the rule does not improve the coherence of the tax system. In fact, strengthening an inappropriate rule arguably reduces the coherence of the system. For this reason, amending the rule to fix its flaws is not officials' preferred option.

Option three – repeal section FA 2(5) in its entirety (preferred option)

22. Option three – repealing the rule in its entirety – is officials' preferred option. It has all the benefits of option two (fixing the flaws in the rule), but it also increases the coherence of the tax system as it removes a rule that no longer fits with our current policy settings.

23. The only potential disadvantages to repealing the rule are that:

a) it arguably buttresses some of our targeted international base protection rules[4] (in some cases it will limit the ability to take excess debt deductions in New Zealand where the other specific rules have been circumvented); and
b) there is still a subset of New Zealand residents who would prefer to receive interest rather than dividends from a tax perspective, so it may provide some limit to the extent to which these entities excessively debt fund.

24. Officials do not see these factors as compelling reasons to retain the rule. First, the thin capitalisation rules (which prevent excess debt deductions by New Zealand companies owned by non-residents) are being strengthened, so they do not require a buttress in the form of the substituting debenture rule. Second, it is very easy to circumvent the application of the rule, so in reality the rule is unlikely to be providing any buttress to the international tax rules or preventing New Zealand residents structuring to receive interest rather than dividend returns where this would be advantageous from a tax perspective.

25. However, if the repeal of the rule results in an increase in aggressive tax structuring, then officials will consider recommending strengthening existing rules or introducing another more targeted measure.

Option four – repeal section FA 2(5) and strengthen other rules

26. The final option considered by officials was a full repeal of section FA 2(5), combined with strengthening other related debt recharacterisation rules to address any gaps left by the absence of the substituting debenture rule.

27. The most appropriate candidate for strengthening is the stapled stock rule,[5] as this rule covers similar arrangements. Officials have identified a number of areas where this rule could be improved; in particular whether it is appropriate to retain the current exclusion from the stapled stock rule for debt and shares stapled using a shareholder's agreement in a company that is not widely held.

28. At this stage, officials do not recommend strengthening the stapled stock rule. This is because:

a) we doubt the repeal of the substituting debenture rule will leave any gaps because it is currently so easy to circumvent;
b) as a separate project, the thin capitalisation rules are being strengthened[6] at the same time as the rule is to be repealed so there is already an element of gap filling in the international context; and
c) we are not aware of the stapled stock rule being abused currently; and if it is being abused the general anti-avoidance rule could potentially apply.

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[4] Such as the thin capitalisation rules, the transfer pricing rules and non-resident withholding tax rules.

[5] The stapled stock rule applies where a company issues shares which are "stapled" to debt. This means they cannot be traded separately and are, in substance, completely interchangeable with equity.

[6] See http://taxpolicy.ird.govt.nz/publications/2013-ip-thin-capitalisation/overview.

29. However, as stated above, it the repeal of the rule results in an increase in aggressive tax structuring, then officials will reconsider this option.

30. The table below summarises the analysis of each option.

Options	Doe it meet the objectives?	Impacts				Net impact
			Fiscal/economic impact	Compliance and administrative costs	Risks	
1. Maintain status quo	No	Taxpayer	If the rule applies, interest deductions denied which results in more tax being paid by the company. However because the rule is easily avoided the real economic costs are probably low.	Unnecessary compliance costs for taxpayers.	Unnecessary compliance costs, administrative costs and lack of confidence in a coherent tax system by taxpayers. This may erode voluntary compliance.	No change as maintains the status quo. This is negative for the tax system and taxpayers because of unnecessary compliance costs and uncertainty.
		Tax system	It is unlikely that the rule currently raises any revenue because it can be so easily circumvented and there is likely to be some non-compliance from lack of awareness of the rule.	There are administrative costs in providing binding rulings and ensuring compliance with legislation.	The rule is potentially being used in aggressive tax structures. This reduces the integrity of the tax system.	
2. Amend section FA 2(5) to fix flaws	Partially	Taxpayer	There will be an economic cost to taxpayers as the rule will deny interest deductions in more cases because it will not be able to be circumvented.	Compliance costs would be reduced. The rule would be clear, easily understood, and certain.	Common transactions will still be caught and small/ unsophisticated taxpayers are likely to still be inadvertently caught. Transactions that seek to avoid the section are more likely to be subject to the GAAR.	Improves on the status quo slightly because the rules will be much clearer, but not the preferred option because the underlying problem with the section remains.
		Tax system	May result in an economic/fiscal gain to the government as more interest deductions will be denied and more tax collected.	Administrative costs are likely to be reduced as fewer rulings would be needed and audit activity would be simpler.	Taxpayer perception of the fairness of the system may be eroded.	
3. Repeal section FA 2(5) (official's preferred option)	Yes	Taxpayer	Economic gain for taxpayers as potentially more interest deduction allowed with less need for structuring.	Reduced compliance costs. The rule would be clear, easily understood, and certain. No chance of inadvertently falling into the rule.	Taxpayers who have structured into the rule will need to unwind their transactions.	Improves on the status quo by increasing coherence of the tax system, reducing compliance and administrative costs and improving the integrity of the system.
		Tax system	As it is unlikely that the rule currently raises any revenue, the fiscal consequences of repeal are expected to be negligible.	Administrative costs reduced as fewer rulings would be needed and audit activity would be simpler.	May be increased aggressive tax structuring.	
4. Repeal section FA 2(5) and strengthen other rules	Yes	Taxpayer	This may result in an economic cost for business as it replaces a rule that is easy to avoid with tougher rules that will potentially deny more interest deductions and result in more tax.	Compliance costs would be reduced.	Transactions that previously did not fall within the strengthed rules may be subject to the strengthened rules.	Improves the status quo by providing more certainty and reducing compliance costs. It improves the coherence of the tax system. May impose new stricter rules on taxpayers unnecessarily. For this reason this is not the preferred option.
		Tax system	Protects the tax base from any transactions that seek to take advantage of the tax difference between debt and equity.	Overall administrative costs would be reduced.	No identified risks	

Social, environmental and cultural impacts of all options

31. There are no social, environmental or cultural impacts associated with any of the identified options.

Net impacts of all options

32. All identified options would be an improvement on the status quo as they provide more certainty and reduce compliance costs for taxpayers. The lack of data makes it difficult to quantify the net impacts, however anecdotal evidence suggests that the rule is causing problems in practice.

CONSULTATION

33. There has been targeted consultation on this measure. This has been through a number of taxpayers and their advisors raising the issue directly with officials and officials have fully considered their submissions.

34. The New Zealand Law Society has recently recommended that the rule be repealed in the context of the thin capitalisation project[7]. Thus far, no submissions have argued that the rule should be retained.

35. Consultation has been limited because:

a) Officials have already considered a number of unsolicited submissions;
b) The amendment is broadly remedial in nature, and the repeal of the rule will largely benefit the private sector. There appears to be unanimous support for the repeal (officials' preferred option) as it is widely acknowledged that the rule no longer serves its original policy purpose; and
c) Taxpayers are able to make submissions at select committee stage and these submissions with be taken into account before the bill is enacted.

CONCLUSIONS AND RECOMMENDATIONS

36. Official recommend option 3 – repealing the substituting debenture rule in its entirety. There has been unanimous support for this approach from the private sector so far. Officials do not see a need to retain any element of the rule, as any residual function it serves is not deliberate and is a blunt instrument at best. However, if the repeal of the rule results in an increase in aggressive tax structuring, then official will consider strengthening the stapled stock rules or introducing some other more targeted measure.

37. Officials recommend the application date of the repeal should be 1 April 2015 to coincide with the strengthened thin capitalisation rules.

38. The strengthening of the thin capitalisation rules addresses some of the concerns officials had in the cross-border area. Domestically, there is only a small group who, from a tax perspective, generally prefer debt over equity. We do not believe this justifies keeping any part of the rule.

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[7] See the letter dated 4 July 2013 "Thin Capitalisation Review: Technical Issues" at: http://www.lawsociety.org.nz/__data/assets/pdf_file/0003/69213/l-IRD-Thin-Capitalisation-Review-Technical-Issues-040713.pdf.

IMPLEMENTATION

39. Officials will seek Cabinet approval to include the necessary legislative changes in the Taxation (Annual Rates, Employee Allowances and Remedial Matters) Bill. These changes will apply for the 2015-16 and later income years.

40. The legislation will contain a transitional provision for taxpayers who have been treating substituting debentures as shares in past income years. The intention of the transitional provision is to ensure that no adverse tax consequences arise on transitioning from treating the debt as a share for tax purposes, to treating is a debt for tax purposes. The transitional provision will deem the taxpayer to have redeemed the substituting debenture for its face value immediately before the beginning of its 2015-16 income year and re-advanced the redemption proceeds under a new loan equal to the face value on the first day of its 2015-16 income year. Any income derived or expenditure incurred in respect of the loan on or after the first day of the taxpayer's 2015-16 income year must be accounted for under the financial arrangements rules. Any income and expenditure arising under the substituting debenture in income years before the 2015-16 income year will not be taken into account under the financial arrangements rules because that income and expenditure will have been dealt with under the share rules.

41. When introduced to Parliament, commentary will be released explaining the amendments, and further explanation of their effect will be contained in a *Tax Information Bulletin* which would be released shortly after the bill receives Royal assent. Officials note that there are no specific implementation risks associated with the recommendations.

MONITORING, EVALUATION AND REVIEW

42. The Inland Revenue will monitor the repeal of the rule to ensure that it does not result in an increase in aggressive tax structuring. However, if the repeal of the rule has this result, then officials will consider recommending strengthening existing rules or introducing another more targeted measure.

43. In general, Inland Revenue monitors, evaluates and reviews new legislation under the Generic Tax Policy Process ("GTPP").

44. The GTPP is a multi-stage process that has been used to design tax policy in New Zealand since 1995. The final step in the process is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of remedial issues. Opportunities for external consultation are also built into this stage.