SPEAKMAN LAW

Is capitalising debt tax avoidance?

Inland Revenue has issued a recent statement to the effect that issuing shares in cancellation of debt owed to a shareholder is tax avoidance. They say it is tax avoidance because of the purpose and effect of avoiding remission income that would otherwise arise if the debt was forgiven/remitted. Inland Revenue's statement is alarming.

Capitalising shareholder loans has been common practice for many years as a means of overcoming remission income. It involves subscription for shares in the company and application of the subscription monies in repayment of the shareholder loans. The result is shares held in substitution for a loan with precisely the same substance underpinning the shares as underpinned the loans. Interestingly, had the shareholder contributed its funds as shares at the outset (and not as a loan), no question of remission income would arise. It is curious therefore that Inland Revenue should consider substituting shares for loans as tax avoidance. All that happens is to put the shareholder (and the company) in the same position it would have been in had the choice of subscribing for shares been taken at the outset. In the usual course of things no tax advantage is available or sought either way. In this light it is odd that Inland Revenue should treat the steps of returning to that position as tax avoidance.

The IRD's view is that repaying the debt out of a fresh share subscription results in the company making an economic gain. Inland Revenue say that Parliament's contemplation is that these gains be taxed. This is premised on the view that the shares being issued are worthless.

The IRD's view is problematic. Essentially it ignores the fact that if the shares being issued were worthless, then so must have been the loans that the shares replace. The economic reality therefore is that there is no gain achieved, only a loss exists for the shareholder for whom there remains no prospect of recovery. It is difficult to believe that Parliament may have contemplated a taxation liability arising in circumstances of loss. It is also difficult to accept that Parliament intended that this tax consequence should operate to deny a company (and its directors) the ability to take steps to improve the solvency of the company and shelter the directors from the results of insolvency.

The New Zealand Law Society has made a submission in response to Inland Revenue's position. Essentially, the Law Society discount all but one of the Inland Revenue's reasons as invalid, leaving only one issue to be examined. In their view the only relevant issue is the value of the shares that are issued in exchange for the cash that is then applied in repayment of the loan. They also comment that Inland Revenue's position ignores the fact that in many situations the purpose of the recapitalisation is to enable the company to continue to trade. The Law Society submit that it should not be a matter of tax avoidance to issue shares with the by-product of avoiding remission income in that situation.

On the question of valuation of the shares, the Law Society distinguish the position of a solvent company from that of an insolvent company. In the case of a solvent company, clearly the shares do have value and consequently the application of the financial arrangements provisions should not result in a tax liability. In those circumstances, there is no room at all to apply the tax avoidance provisions.

The principal issue is therefore whether debt capitalisation by an insolvent company is tax avoidance. My own view will be evident from my comments above, namely the debt capitalisation does not constitute tax avoidance. (A tax liability on calculation of a base price adjustment under the financial arrangements rules is possible, but that is a different analysis.)

The Law Society, in their submissions reach the same conclusion, evidently for much the same reasons. They point out that the purpose of a debt capitalisation is in many cases to establish a more secure capital base. More significantly perhaps, and as noted earlier, they comment that in many cases shareholder loans are a

form of interim funding, interchangeable with shares. Had shares, and not loans, been issued in the first instance, there would be no debt forgiveness income. Accordingly, debt capitalisation does not change the incidence of or liability to income tax.

It will be interesting to see if there is any movement in the Inland Revenue's position in response to the Law Society's submissions. In any event it is strongly hoped that Inland Revenue do not choose to apply the law this way.