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Our ref 150215KPMGSubGP

11 February 2014

Dear Megan / Grant

**QB 14/xx - Deductibility of Guarantee Payments**

Further to our e-mail correspondence and telephone conversation last year, we provide our comments on the *Draft QB 14/xx – Deductibility of Guarantee Payments* (the "QB").

The draft raises a number of questions. We have not reached an answer on all of these but outline our analysis below.

## The capital prohibition

We understand that *McElwee* is used for support for the proposition that the payment under a guarantee does not have a nexus to income and is therefore a capital payment.

The *McElwee* case concerned a guarantee payment where no fee was received. The taxpayer tried to establish a connection to the taxpayer's other income earning processes. The Court decided there was none.

The analysis and examples in the QB include a guarantee fee. We consider that *McElwee* does not support a capital non-deductible conclusion in these circumstances. Broadly:

- The Act defines expenditure under the financial arrangement rules to be interest (see paragraph (c) of the definition of "interest" in section YA 1 of the Income Tax Act 2007). The deductibility of interest is not limited by the capital prohibition (see sections DB 6, DB 7 and DB 8).
- We consider that the conclusion in paragraph 2 of the QB, to the extent it concludes a deduction is denied due to the operation of the capital prohibition, and paragraph 12 is therefore incorrect.
- The Act does not require the production of income after the expenditure is incurred. Any timing element that may have been there has been removed with the rewrite of the Income Tax Act.
- Assessable income will have been produced in prior years. The guarantee payment is clearly connected to the guarantee fee received. It is connected to the guarantor's income earning process. (Paragraph 11 of the QB accepts this conclusion).

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## A single arrangement

We note the statement at paragraph 26 of the QB that there will be a right of recovery.

We assume, but have not confirmed, that there is an ability to exclude the operations of sections 84 and 85 of the Judicature Act 2008. It would be useful for the statement to include the Commissioner's view if those provisions are excluded.

Otherwise, we understand that the Commissioner's view is that the guarantee and the right of recovery form a single arrangement so that a base price adjustment is required/able to be performed only when that right of recovery terminates.

## The effect of the rules prior to termination of the arrangement

### *Cash basis holder*

Based on our view of the capital prohibition above, the comments at paragraph 42 appear to be incorrect. In example 1, Angela would have net interest expenditure of $4,000 in year 2 which is not denied a deduction by the capital prohibition. Section DB 6 would appear to give her a deduction in year 2.

### *IFRS taxpayers*

An IFRS taxpayer is entitled to account for a financial arrangement in accordance with section EW 15D assuming that no other provision requires an alternative method (see sections EW 15H and EW 15I). Under that method, the taxpayer must spread income/expenditure to the income year the relevant amount is allocated under the IFRS rules, except for credit impairment adjustments.

We would expect an IFRS taxpayer to account for guarantee fees as they are due. This is consistent with paragraph 8 of the QB. We would also expect an IFRS taxpayer to account for:

- Any payments, when made;
- Any recoveries, when received;
- The right of recovery is likely to be valued at nil (on the assumption that if the guarantee payment is made, the guaranteed party is not in a position to pay).

We expect that the gross value of the right of recovery is never recognised so that, for financial reporting purposes, the only amount recognised in the year of payment is the net payment (after any recovery). This raises the question of whether the net recognised expense is an impaired credit adjustment for the purposes of section EW 15D(3). We have not reached a conclusion on this question and submit that the Commissioner should consider it and include this in her finalised statement. We would be happy to discuss this further.

## Section DB 14

In our view, section DB 14 potentially applies to a guarantor. Using example 1 in the QB, and assuming that Angela is not entitled to a deduction for the $5,000 payment, she would be entitled to a deduction for $1,000 to match the amount recovered from Winger Ltd. This would change the conclusion in paragraph 46 as Angela would be allowed a deduction for $1,000 (see below).

We also note that section DB 14, in its interaction with section EW 51, appears circular as each appears to depend on the other. Further, in principle, the deduction should be limited to the lesser of the loss and the security payment.

### *The base price adjustment*

We note that consideration excludes the amount remitted. This means that the Commissioner's view is that the amount remitted is not consideration that will be payable.

Under example 1, an alternative base price adjustment formulation could be:

($1,500 – $5,000) – ($500) + ($0) + $4,000 = 0

As:

"Income" is the $500 fee plus nil as a result of section DB 14 which allows the recovery to be offset by a deduction to the extent of the security payment.

"Expenditure" is nil consistent with the Commissioner's view that no deduction is allowed for the remainder of the guarantee payment. If the Commissioner considers that the guarantee payment is expenditure incurred, then the Commissioner must explain why sections DB 6 to 8, along with the section YA 1 definition of "interest", do not apply to allow a deduction. While we have not performed any detailed research to confirm this, it appears to us that "expenditure" is intended to capture deductible expenditure, consistent with the base price adjustment being a wash up to ensure that the correct net income/expenditure is ultimately returned from the financial arrangement.

The other amounts remain unchanged.

On this analysis, section EW 31(3) is not applicable as the base price adjustment does not produce a positive result.

## Bad debt deduction – Example 3

We note that paragraph 56 confirms that a bad debt deduction under section DB 31(2) is available to offset the base price adjustment income. Both this and the base price adjustment appear to assume that the amount is written off as bad in year 3. In other words, no question arises whether the bad debt deduction is expenditure incurred in a prior year.

We assume that a bad debt write off in year 2 would not alter this conclusion as this is a loss suffered rather than expenditure incurred. Alternatively, the Commissioner may consider that section DB 31(3) would prevent a deduction until income arises under the base price adjustment. It would be helpful to have Inland Revenue's confirmation of which of these two approaches applies.

## Section DB 15

We acknowledge that section DB 15 may deny a deduction should it apply. However, it would be helpful to have Inland Revenue's comments on why, and how, section DB 15 overrides sections DB 6 to 8. (We assume this is on the basis that DB 15 is a particular rule while sections DB 6 to 8 are general rules).

### *Example 2 – deliberately manufacturing a guarantee payment*

We acknowledge that the application of section DB 15 will be a factual test, applied to the circumstances of the case. However, example 2 raises the question of whether the occurrence or non-occurrence of an event requires a deliberate action. For example, if FGL planned the work on the basis of a reasonable expectation that *x* number of staff were required to complete the plumbing work but it turned out that in fact they needed *y* number of staff, does this change the Commissioner's answer?

In our view, a purpose of manufacturing a guarantee payment to generate a deduction can be reasonably inferred from the statutory language. The reference to occurrence or non-occurrence is therefore to a deliberate action or failure to act rather than a normal business failure.

It would be useful for the Commissioner to expand on her example and reasons.

### *Cross-border guarantee fees*

A taxpayer granting a guarantee to a foreign associate is required by New Zealand's transfer pricing rules to charge a guarantee fee, which will be taxable income to the grantor. In the Commissioner's draft view, the taxpayer's ability to deduct any guarantee payment is limited by section DB 15.

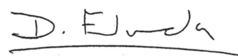
If there was no guarantee fee, per *McElwee*, there is unlikely to be any deduction for a guarantee payment. There would not be a taxable/non-deductible mis-match.

This asymmetry suggests that section DB 15 should not be restrictively interpreted.

## Overall comment

We trust that our comments are clear and helpful. We would be pleased to discuss them further. Please do not hesitate to contact John on (04) 816 4518 or Darshana on (09) 367 5940.

Yours sincerely



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