

Qualifying companies: implementation of flow-through tax treatment

An officials' issues paper

May 2010

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and the New Zealand Treasury*

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Chapter 1

INTRODUCTION

- 1.1 As part of Budget 2010, the Government announced that it would replace the current qualifying company rules with a new set of rules to make qualifying companies and loss attributing qualifying companies (LAQCs) flow-through entities for income tax purposes, similar to the treatment of limited partnerships. As a result, a company's income and losses would both be passed on to shareholders, so income would be taxed and losses deducted at a shareholder's marginal tax rate.¹ The purpose of the change is to address a number of problems with the current qualifying company rules which undermine the integrity of the tax system.
- 1.2 This issues paper seeks comment on the implementation and transition details of moving qualifying companies to flow-through treatment for income tax purposes.

Background to the qualifying company rules

- 1.3 The qualifying company rules were introduced in 1992 after a review of the tax system by the Valabh Committee.² In its report on the taxation of distributions from companies, the Valabh Committee recommended the introduction of a new elective regime for closely held New Zealand-resident companies. The regime would treat a qualifying company and its shareholders as one entity for income tax purposes, similar to the tax treatment of partnerships.
- 1.4 The primary purpose of the qualifying company rules was to remove the tax disincentive faced by the owners of closely held businesses who wish to operate through a company. Attaining the benefits of limited liability afforded by a corporate form meant sole traders and partnerships lost the ability to be taxed at the level of the owner.
- 1.5 The qualifying company rules have applied from the 1992–93 income year.

Current qualifying company rules

- 1.6 The qualifying company rules provide shareholders of closely held companies a form of partnership treatment for income tax purposes, while maintaining the corporate protections afforded under general law (such as a separate legal entity status and limited liability). Income is initially assessed at the company level. On election to be a qualifying company, the shareholders agree to be personally liable for their share of the company's income tax liability that is not met.

¹ The term "shareholder" is used in this paper and refers to a person with an interest in a qualifying company, despite the company being treated as a partnership for income tax purposes in order to apply flow-through treatment.

² Consultative Committee on the Taxation of Income from Capital, appointed in 1989 and chaired by Mr. Arthur Valabh.

- 1.7 Dividends paid out by qualifying companies are taxable only to the extent that imputation credits are available. When a qualifying company has no imputation credits, any dividends paid out are tax-free. As a result, shareholders can have tax-free access to the company's capital gains without having to wind up the company.
- 1.8 The LAQC rules are a subset of the qualifying company rules. A company must satisfy additional criteria to be an LAQC. Like qualifying companies, income is also initially taxable at the company level. Unlike qualifying companies, however, an LAQC's net losses are allocated to shareholders in proportion to their effective interest (generally based on voting interest) in the company. A loss will either be allowed as a deduction from the shareholder's annual gross income or it will be carried forward.

Problems with the current rules

- 1.9 There are significant problems with the current LAQC rules which result in risks to the tax base. These are discussed in more detail below.

Arbitrage opportunities

- 1.10 The qualifying company and LAQC rules were implemented when the company rate and top individual tax rate were aligned at 33 percent. Since their introduction, a gap has opened up between the top individual tax rate (currently at 38 percent, but at 33 percent from 1 October 2010) and the company rate (currently 30 percent, but reducing to 28 percent from the 2011/12 income year). Income is initially assessed at the entity level, so profits are taxed at the company rate. With LAQCs, any losses can be allowed as a deduction from a shareholder's annual gross income, which may be taxed at a higher rate. This disparity creates arbitrage opportunities and tax base integrity pressures.
- 1.11 The amount of losses that can be deducted from an LAQC shareholder's other income may not be commensurate with the level of financial risk that the shareholder faces. That is, there are no loss limitation rules equivalent to those for limited partnerships, despite the similarity in economic terms between an LAQC shareholder and a limited partner. LAQC shareholders can deduct losses in excess of their equity in the LAQC. This is subject to the rules limiting deductions for arrangements involving money not at risk (sections GB 45 to GB 48 of the Income Tax Act 2007). While these rules have restricted schemes promoted using LAQCs, they are narrower in scope than the limited partnership loss limitation rules. The absence of comprehensive loss limitation rules is likely to distort efficient decision-making and resource allocation as a result of allowing investors to claim larger tax losses than their true economic losses.

Remission income inconsistency

- 1.12 An inconsistency in the LAQC rules allows shareholders to benefit from allocated losses but to avoid liability for an LAQC's income tax. Generally, a taxpayer can claim a deduction for an expenditure or loss for income tax purposes when it is incurred, even if payment has not taken place. The Income Tax Act 2007 claws back the unpaid portion of expenditure or losses through the remitted income rules. This does not occur in the case of LAQCs, as the benefit of the loss is enjoyed by the shareholders but the remitted income is derived by the LAQC.
- 1.13 Remission income arises in the year of remission, rather than in the year in which the deduction was originally claimed. If remission income arises in an income year after the company has revoked its LAQC status, the directors and shareholders are not personally liable for the tax liability of the company, as that only applies for an income year during which the company is an LAQC. As a result, shareholders can claim LAQC losses and then eliminate personal liability for the tax on the remitted income simply by revoking LAQC status before remission income is derived by the company, which may not be able to pay the tax on that income.

Structuring around partnership rules

- 1.14 The 2006 discussion document, *General and limited partnerships – proposed tax changes*, raised the possibility of LAQCs being used to structure around the limited partnership loss limitation rules.³ Loss limitation rules restrict the amount of losses that can flow through to a limited partner to the amount of that partner's investment in the partnership. The loss limitation rules apply only to limited partners (as they have limited liability).
- 1.15 Currently, LAQCs can be used as partners in a general partnership to allow net tax losses in excess of the equity invested in the partnership to flow through to the individual LAQC shareholders, even though the LAQC vehicle serves to provide limited liability to the shareholders. This structure circumvents the policy intent behind the limited partnership loss limitation rules.
- 1.16 LAQCs can also be used to circumvent the disposal provisions under the partnership rules while shareholders still receive the benefit of loss flow-through, similar to partners in a partnership. For example, an individual can invest in forestry through an LAQC, receive its losses, and sell the shares in the company for a non-taxable gain, instead of investing in a forestry partnership and being taxed on any gain on disposal of their partnership interest.

³ *General and limited partnerships – proposed tax changes*, June 2006, p.42.

How to make a submission

- 1.17 Officials invite submissions on the matters raised in this issues paper concerning the implementation details of making qualifying companies flow-through entities for income tax purposes. Submissions should be made by 5 July 2010 and be addressed to:

Qualifying company reforms
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington 6140

Or email policy.webmaster@ird.govt.nz with “Qualifying company reforms” in the subject line.

- 1.18 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.
- 1.19 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider there is any part of it that should properly be withheld under the Act should clearly indicate this.

Chapter 2

FLOW-THROUGH OF INCOME AND LOSSES

Flow-through treatment

- 2.1 The Government has decided to replace the existing qualifying company rules with new rules making qualifying companies and LAQCs flow-through entities for income tax purposes. Qualifying companies are currently subject to company tax treatment, whereby income is taxable and losses deductible by the company at the company tax rate. In addition, LAQCs are partially transparent entities in which income is retained at the company level but losses can flow through to individual shareholders. Attributed losses are treated as if they were incurred by a shareholder in deriving their income, and so can be offset against the shareholder's other income or be carried forward to future years.
- 2.2 With flow-through treatment for income tax purposes, a qualifying company's income and losses will both be passed on to shareholders. That is, they will not be retained at the company level. Instead, income will be taxed and losses deducted at a shareholder's marginal tax rate. The company's tax treatment will be integrated with the tax treatment of the owners, on the basis that entities are agents for their owners.
- 2.3 Flow-through will be based on the rules currently applying to partnerships and will be primarily achieved by the rules in section HG 2 of the Income Tax Act 2007. In general, the ordinary partnership tax rules will apply to shareholders of qualifying companies under the new rules. For example, instead of fringe benefit tax (FBT) applying to the provision of a motor vehicle to a shareholder-employee, an apportionment of costs based on private and business use would have to be made, in accordance with existing partnership treatment. Similarly, section DC 4, which allows a deduction for working partner salaries, would be applicable.
- 2.4 This change will erase the distinction between qualifying companies and LAQCs, as both entities will be transparent. There will be only one classification under the new qualifying company rules.
- 2.5 Approximating partnership tax treatment will necessitate amending the definition of "company" in section YA 1 of the Income Tax Act to exclude qualifying companies. Without this change, a qualifying company would still be characterised as a company for income tax purposes, so the company's income and expenses would not flow through to the shareholders but would instead be taxed and deducted at the company level. The definition of "partnership" will be amended to include a qualifying company. Similarly, the definition of "partner" will be amended to include a member of a qualifying company. These will be the primary amendments through which flow-through will be achieved, as qualifying companies will be brought within the scope of subpart HG and, in particular, section HG 2.

- 2.6 As a result of this change, the limited partnership and qualifying company tax rules will be largely aligned, with limited partners and qualifying company shareholders being treated the same for income tax purposes. Both entities will be transparent for income tax purposes while remaining separate legal entities at general law. However, some differences between the regimes, relating to the underlying structure of the entity, will remain. In particular, qualifying company shareholders will be able to take an active role in the management of the company while retaining limited liability, unlike limited partners in a limited partnership who may not participate in the management of the partnership.

Tax treatment of closely held entities

- 2.7 The Tax Review 2001 considered that closely held entities (with five or fewer members) should be taxed on a partnership basis, and widely held entities be taxed on a company basis.⁴ Partnership tax treatment recognises the close economic connection between an entity and its members, and ensures that the income of closely held entities are taxed at the marginal tax rate of the ultimate beneficial owner.
- 2.8 Flow-through treatment for qualifying companies is consistent with this approach. Qualifying companies and their shareholders will be treated as a single economic entity, which is the original rationale for the qualifying company and LAQC rules. Flow-through treatment will more closely integrate the taxation of the company and its shareholders. The role that taxation factors play in the choice of business entity will be reduced, as flow-through qualifying companies and partnerships (general and limited) will be more substitutable.

Addressing current concerns

- 2.9 Flow-through treatment will address concerns with the current rules, in particular, arbitrage opportunities and the risk to tax base integrity, and the use of LAQCs as vehicles for tax avoidance or structuring around the limited partnership loss limitation rules. It will also fix the remission income inconsistency.
- 2.10 With partnership tax treatment, both the company's income and losses would be passed on to the shareholders, so income would be taxed and losses deducted at a shareholder's marginal tax rate. As a result, there would be no arbitrage opportunities due to the difference between company tax and higher personal tax rates – the company tax rate will not apply for qualifying companies. This treatment will therefore improve the integrity and coherence of the tax system.

⁴ Tax Review 2001, *Final Report*, October 2001, p.69.

- 2.11 This change will address the potential for LAQCs to be used as partners in general partnerships to structure around the limited partnership loss limitation rules. The proposed loss limitation rules for qualifying companies will prevent excessive losses from flowing through to shareholders via a qualifying company general partner.
- 2.12 The inconsistency in the LAQC rules that allows shareholders to benefit from allocated losses but to avoid liability for the company's income tax will be closed by moving to flow-through tax treatment. Shareholders of a qualifying company will not be able to eliminate their liability for the company's income tax (by revoking LAQC status) as all the company's income – including deemed remission income – will instead be automatically taxed at the shareholder level.

Distributions and dividends

- 2.13 Applying partnership tax treatment will mean that qualifying companies will no longer, for income tax purposes, pay dividends to shareholders, as no income will be retained by the company under the new rules. Instead, profits and losses will be allocated directly to shareholders without going through the imputation system. This is a natural consequence of flow-through tax treatment. This will allow the current qualifying company rules to be significantly simplified. A number of sections in the Income Tax Act will be able to be removed, including section CW 15 and sections HA 14 to HA 16.
- 2.14 Similar to the existing limited partnership rules, any amounts earned by a qualifying company will retain their character in the shareholder's hands. For example, capital gains will retain their character because they will be treated as being earned directly by the shareholder and, therefore, will generally not be subject to tax.
- 2.15 Qualifying companies will not need or be able to operate an imputation credit account. This will reduce compliance costs for closely held companies. However, if the qualifying company election is revoked or the requirements cease to be met, the qualifying company will revert to being an ordinary company and normal company tax treatment, including the maintenance of an imputation credit account, will apply.
- 2.16 Distributions to non-residents are currently subject to non-resident withholding tax (NRWT). With flow-through treatment, however, non-resident shareholders of a qualifying company will be allocated their portion of the company's income and expenditure, and any actual distributions from the qualifying company to non-resident shareholders will not be recognised for NRWT purposes. However, the underlying income may be subject to NRWT. For example, dividends paid by New Zealand-resident companies to a qualifying company will be allocated to the qualifying company's non-resident shareholders according to their effective interest in the company and subject to NRWT.

Removal of current shareholder liability for company's tax

- 2.17 The current liability of qualifying company shareholders for a company's unpaid income tax will be removed. This is a natural consequence of flow-through treatment.

Treatment of foreign losses

- 2.18 Currently, LAQC losses are deductible against a shareholder's other income, but foreign-sourced controlled foreign company (CFC) and some foreign investment fund (FIF) losses can only be offset against CFC and FIF income. That is, CFC and some FIF losses are ring-fenced. It is therefore possible for shareholders not to be able to receive the benefit of foreign losses if they have no available foreign income to offset the losses against.
- 2.19 Section HA 25 of the Income Tax Act provides that an LAQC may elect to retain attributed CFC and FIF net losses at the company level instead of passing such losses to shareholders, to facilitate later use of these losses. Any retained losses may be offset against the company's foreign income in subsequent years. However, flow-through treatment means that losses will not be able to be retained at the company level to be carried forward for future years. Furthermore, there will be no income retained by the company against which the losses can be offset.
- 2.20 It is therefore proposed to remove section HA 25, which will prevent qualifying companies from electing to retain foreign losses at the company level. Instead, foreign losses will automatically flow-through to shareholders and will be subject to the normal rules for attributed CFC and FIF losses in subpart DN of the Income Tax Act.

Shareholder's effective interest

- 2.21 The basis for the allocation of a qualifying company's income tax liability and losses to a shareholder, as well as certain shareholder elections, is the shareholder's "effective interest" in the company. The meaning of effective interest is set out in section HA 43 of the Income Tax Act. It generally means a shareholder's voting interest in the company – for example, based on the number of shares held. However, if a market value circumstance exists, a shareholder's effective interest is the average of their voting interest and market value interest. If a shareholder's interest changes during an income year, a weighted average is used.
- 2.22 It is proposed to maintain the same definition of "effective interest", in sections HA 43 and 44 of the Income Tax Act, under the new qualifying company rules.

Anti-streaming rule

- 2.23 Under the new qualifying company regime, it is proposed that assessable income, exempt income, excluded income, expenditure, capital gains and capital losses will be apportioned by the qualifying company to each shareholder in accordance with each shareholder's effective interest in the company. Shareholders will derive income and expenses from each source and would then include these amounts in their tax return for the appropriate income year. This anti-streaming rule will be similar to that applying for partnerships in section HG 2(2) of the Income Tax Act, and follows the approach recommended by the Valabh Committee.
- 2.24 This rule will ensure income or losses from particular sources – for example, foreign-sourced income – cannot be streamed to the shareholder who would benefit the most. Without an anti-streaming rule, certain types of income that are exempt from tax (such as capital gains) could be disproportionately allocated to shareholders on higher marginal tax rates, and taxable income could be allocated to shareholders on lower marginal tax rates in order to reduce the amount of tax payable. Such a rule will help protect the integrity of the tax system, as well as provide certainty in the allocation of income and expenditure.

Chapter 3

ELIGIBILITY REQUIREMENTS

- 3.1 There are several criteria that companies must satisfy to become qualifying companies. In particular, a company must be tax-resident for all of the income year, must be closely held (five or fewer shareholders) unless it is a flat-owning company, must meet certain shareholding criteria (a shareholder must be a natural person, another qualifying company, or an eligible trustee), may not be a unit trust, and may not earn more than \$10,000 foreign non-dividend income in an income year.
- 3.2 Because of the potential for abuse of the LAQC rules due to the streaming of losses to shareholders best able to use them, LAQCs must meet additional requirements. First, there must be only one type of share (section HA 10 of the Income Tax Act). All shares must have the same rights concerning, for example, receiving distributions and the appointment of directors. LAQCs must also meet an additional anti-avoidance requirement in section HA 12.

Eligibility for new rules

- 3.3 It is proposed to maintain the current general qualifying company eligibility requirements for the new regime, with some modifications. This recognises that the new qualifying company rules, like the old rules, are designed for closely held New Zealand-resident entities. Keeping mostly the same rules will also minimise compliance costs for businesses.
- 3.4 Officials propose to remove the requirement in section HA 8B of the Income Tax Act that a qualifying company must not have income interests in a CFC or attributing interests in a FIF that are a direct income interest of 10 percent or more. Similarly, we propose removing section HA 9 which prescribes that a qualifying company may not have more than \$10,000 of foreign non-dividend income in any particular income year. Such investment and income restrictions mainly apply because unimputed dividends paid out by qualifying companies are currently exempt in a shareholder's hands. These restrictions are unnecessary with flow-through tax treatment because qualifying company shareholders will be directly allocated their share of any foreign-sourced income.

Elections

- 3.5 Shareholders and directors are required to elect into the qualifying company regime, as set out in sections HA 5 and HA 28 to HA 37 of the Income Tax Act. Shareholders must also elect to take personal liability, according to their share in the company, for the company's income tax liability that is not met.

- 3.6 Submissions are sought on whether the current election (and revocation of election) provisions should be retained or amended for the new qualifying company rules, subject to the entry and exit rules; in particular, whether the elections in and out of the rules should operate prospectively only, that is, from the start of the following income year.
- 3.7 As income will automatically flow through to shareholders, the shareholder election to be personally liable for the company's income tax, in section HA 8, is redundant and will therefore be removed.

One class of share requirement

- 3.8 The Valabh Committee in its final report considered that, if the flow-through of losses was extended to income as well, the one share requirement would be necessary. Officials propose that the current one share requirement for LAQCs should be included as a general requirement for qualifying companies under the new rules.
- 3.9 The one share requirement would help ensure that the allocation of income and losses to shareholders is as simple as possible. This is necessary to avoid complex allocation rules for income and losses under different classes of shares. However, it would increase the number of requirements that companies would need to meet to become qualifying companies. By comparison, limited partnerships do not have a similar eligibility requirement. This requirement may have implications for existing qualifying companies (not also being LAQCs) which currently have more than one class of share. In order to transition into the new qualifying company rules, such qualifying companies would need to have only one class of share – for example, by amending the company's constitution – before 1 April 2011.
- 3.10 Maintaining this requirement would reduce the ability for income and losses to be streamed to particular shareholders, as each share must have the same allocation of income and losses as every other share. The proposed anti-streaming rule would provide similar protection against streaming.

Chapter 4

DISPOSAL EVENTS

- 4.1 With flow-through tax treatment, a shareholder of a qualifying company would be treated as carrying on the activities of the company, and having the status, intention and purpose of the company. A shareholder would also be treated as holding the property that a qualifying company holds. This is the same approach as under the existing partnership rules.
- 4.2 The following events would result in qualifying company shareholders being treated as disposing of their interest in the qualifying company, with resultant tax consequences:
- a shareholder disposes of their shares in a qualifying company;
 - a qualifying company ceasing to meet or electing out of the qualifying company rules; and
 - the liquidation of a qualifying company.

Disposal of shareholder interest in a qualifying company

- 4.3 If a shareholder disposes of their interest in a qualifying company, they would, under the new rules, be treated as disposing of their share of the underlying company property, including any revenue account property, and would bear any tax consequences associated with the disposal. This is a natural consequence of flow-through treatment applying. However, it could result in significant compliance costs for qualifying companies and their shareholders.
- 4.4 Sections HG 5 to HG 10 of the Income Tax Act are special disposal provisions designed to reduce compliance costs for partners and partnerships. It is proposed to apply the same rules for qualifying companies to reduce the tax consequences of a deemed disposal of shareholder interests.
- 4.5 The application of these rules to qualifying companies would remove the requirement for an exiting shareholder to account for tax when the tax adjustment that would otherwise be required is below certain thresholds. A shareholder will be required to account for tax on disposing of their interest in a qualifying company only if the value of the proceeds from the disposal exceeds the total net tax book value of their share of company property by more than \$50,000. However, if the \$50,000 threshold in section HG 5 is exceeded, an exiting shareholder would not need to account for tax in certain circumstances. These exclusions would be the same as for partnerships and are contained in sections HG 5 to HG 10 of the Income Tax Act.

Qualifying company status ending

- 4.6 If a company revokes its election into the qualifying company regime or fails to meet the eligibility requirements, flow-through treatment would cease to apply and the company would be subject to normal company taxation rules generally from the start of that income year. Companies who elect out of the qualifying company regime could choose for this to apply from the start of a subsequent income year.
- 4.7 When a company ceases to be a qualifying company, there would be a deemed disposition and reacquisition of the company's assets at their market value on that date. This would give rise to tax consequences for the shareholders, who would be treated as disposing of their share of the qualifying company's property. For example, shareholders would be liable to tax on any gain from revenue account property. The company (which has lost its qualifying company status) would be treated as having acquired the property at its market value. The company's available subscribed capital would be based on any capital contributed by the shareholders under the Companies Act 1993. To ensure that double taxation does not arise on eventual distribution, the portion of shareholder funds that represents undistributed reserves of a revenue nature will be treated as a capital gain amount.

Disposal on liquidation

- 4.8 On liquidation of a qualifying company, the disposal provisions in section HG 4 would apply. A shareholder of a qualifying company would be treated as disposing of and reacquiring all their interests in the company at market value. This would give rise to tax consequences – for example, for property held on revenue account. Thus, the tax treatment of a qualifying company on liquidation and a partnership on final dissolution will be aligned.

Chapter 5

LIMITATION OF SHAREHOLDER TAX LOSSES

- 5.1 The limited partnership rules contain loss limitation rules which prevent the flow-through of losses in any income year to limited partners in excess of the actual investment of the limited partner. A limited partner's tax loss is restricted if the amount of the loss exceeds the carrying tax value of that partner's investment. Disallowed losses in any year may be carried forward to future years.
- 5.2 This rule applies only to limited partners because they are not exposed to any risk of loss greater than the amount of their investment in the limited partnership. In contrast, general partners have unlimited liability and therefore exposure to the risk of loss.
- 5.3 Currently, the flow-through of LAQC losses to shareholders is subject to "at risk" rules in sections GB 45 to GB 48 and section HA 27 of the Income Tax Act. However, these rules do not prevent the flow-through of losses in excess of a shareholder's equity in the LAQC, which is the treatment under the limited partnership loss limitation rules.

Proposed loss limitation rules

- 5.4 As no loss limitation rules similar to those for limited partnerships apply in the current LAQC regime, an LAQC shareholder can deduct losses in excess of their equity in the LAQC. The amount of losses may not be commensurate with the level of financial risk that the shareholder faces. Therefore, officials propose implementing loss limitation rules for the new qualifying company regime, similar to the rules applying to limited partnerships. These rules would allow shareholders to offset, for tax purposes, net tax losses only to the extent of the shareholder's investment in the qualifying company.
- 5.5 If the allocated losses exceed the value of the shareholder's investment in the qualifying company for tax purposes, the excess losses may be carried forward by the shareholder until, for example, the shareholder's investment in the company increases. The basis for measuring a shareholder's investment in a qualifying company is discussed later in this chapter.
- 5.6 Tax losses of a qualifying company will be allocated to shareholders and treated as those of the shareholders themselves. Therefore, losses may be offset without any special restrictions against other income, just as if the losses had been the shareholder's directly.

Policy rationale

- 5.7 The rationale behind restricting a shareholder's tax losses in any given year is to ensure that the tax losses claimed reflect the actual level of that shareholder's economic loss.
- 5.8 Shareholders have limited liability in relation to their interest in the qualifying company, so do not have exposure to losses greater than the amount of their investment in any year. As shareholders cannot lose more than the amount of their investment, it is not appropriate for shareholders to take a deduction for a greater amount. Therefore, it is the correct policy result to allow shareholders to offset, for tax purposes, only those tax losses they have exposure to.
- 5.9 In the absence of such rules, qualifying companies would provide opportunities for taxpayers to receive tax deductions in excess of the expenditure they personally have at risk in the qualifying company. The absence of such rules may therefore distort efficient decision-making and efficient resource allocation, by encouraging investors to enter arrangements or schemes whereby small amounts of capital are invested to get access to larger net tax losses. This could result in abuse of the new qualifying company rules and in actions that are contrary to their intent.
- 5.10 It is international practice to limit the flow-through of losses of a transparent entity to its members where their liability is limited. This occurs, for example, in the United States and Australia (such as for venture capital limited partnerships).

Membership basis

- 5.11 A shareholder of a qualifying company will only be able to offset allocated losses to the extent of their investment in the company. To measure a shareholder's level of investment in the company, officials propose to adopt a qualifying company membership basis similar to the "partner's basis" in section HG 11 which applies for limited partners. This would include the share of any debt guaranteed by the shareholder.
- 5.12 If a tax loss exceeds a shareholder's basis because the shareholder has insufficient equity in the qualifying company, the tax loss would not be included in the shareholder's annual total deduction. In other words, it cannot be offset against the shareholder's other income. Instead, it can be carried forward by the shareholder to use in a future year if the shareholder has sufficient basis in the qualifying company to offset the loss.

Anti-avoidance

- 5.13 Section HG 11(9) of the Income Tax Act provides that any investment into a partnership within 60 days of the end of the year which is subsequently reduced within 60 days after the year end will be disregarded for the purposes of calculating a shareholder's membership basis. This is an anti-avoidance rule that prevents an artificially high basis around the end of the income year, in order to increase the flow-through of losses. Officials propose a similar anti-avoidance rule for the new qualifying company rules.

Example of loss limitation

John and Colleen jointly own a company and elect into the new qualifying company rules with application from 1 April 2011. John owns 75 percent of the shares. The total equity investment in the company is \$100,000. The company earns gross income of \$20,000 during the year and distributes \$10,000 to John and Colleen in proportion to their interest in the company.

John's share of the equity investment is therefore \$75,000 (75 percent of \$100,000). He has a 75 percent share of the company's income and distributions, which equal \$15,000 and \$7,500 respectively. John's membership basis in the qualifying company is calculated as follows:

Original investment	\$75,000
Income	\$15,000
Distributions	(\$7,500)
Deductions taken in previous years	(\$0)
Disallowed amounts	(\$0)

John's membership basis in the qualifying company is therefore \$82,500.

In the 2012/13 income year, the qualifying company makes a loss of \$120,000. John's share of the tax loss is \$90,000 (75 percent of \$120,000). The proposed loss limitation rules, which will limit the amount of losses allowed as a deduction to the amount of the shareholder's membership basis, are applied to John as follows:

Membership basis	\$82,500
Allocated losses	(\$90,000)
Allowable tax loss	(\$82,500)

Therefore, John is allowed a tax loss of \$82,500, which can be deducted from his other income.

The proposed loss limitation rules mean that John is disallowed a tax loss to the value of \$7,500 (\$90,000 less \$82,500). This loss cannot be included in his annual tax calculation for the 2012/13 income year as a deduction, and so cannot be offset against his other income. The disallowed loss can, however, be carried forward by John and used in a subsequent year if John's membership basis in the qualifying company is sufficient. (The allowable tax loss taken as a deduction in the 2012/13 income year will reduce John's membership basis for later income years by that amount.)

Chapter 6

ADMINISTRATION AND COMPLIANCE

Tax returns

- 6.1 Section 42 of the Tax Administration Act 1994 sets out the return filing obligations of partnerships and partners. Partners are required to complete a joint income return for the partnership income and expenditure, and separate individual returns which include amounts allocated to the partner as a member of the partnership. Officials propose to follow a similar approach for qualifying companies.
- 6.2 A qualifying company under the new rules would not file a company tax return (IR4). This is because a qualifying company's income and losses would not be retained at the company level but would be passed through to shareholders. Unlike ordinary companies, therefore, qualifying companies would have no tax payable and, for example, no imputation credit account to maintain. Instead, a qualifying company would be required, under section 42, to complete a partnership income tax return (IR7) which is appropriate for flow-through taxation. An IR7 form will include the details of each shareholder and the amounts allocated to each for the relevant income year. A qualifying company would still use the same "tax file number" (IRD number) while using an IR7 form, and would be treated as an entity for return filing purposes even though it is not assessed for tax.
- 6.3 Individual shareholders of a qualifying company would be required to separately include any allocated income and expenses from the qualifying company in their individual income tax return (IR3) for an income year.
- 6.4 A qualifying company (A) which is a shareholder in another qualifying company (B) would be allocated income and expenditure from company B in proportion to its effective interest. Both qualifying companies would need to file an IR7 return. Income allocated from company B to company A would subsequently flow through to company A's shareholders, along with company A's other income.
- 6.5 Trustee shareholders of qualifying companies would need to include any allocated income and expenditure from the qualifying company in their IR6 return.

Information requirements and record-keeping

- 6.6 The Taxation (Limited Partnerships) Act 2008 amended section 22 of the Tax Administration Act 1994. The amendment clarified that it is the partnership, rather than each partner in the partnership, that must maintain records.

- 6.7 It is not necessary for both shareholders and the qualifying company to keep business records. Therefore, it is proposed that shareholders of a qualifying company will not be required to retain any records if the company retains the necessary records under section 22 of the Tax Administration Act 1994. This is consistent with the record-keeping requirements for partners and partnerships. This is an example of a qualifying company being treated as an entity despite the general look-through rule in section HG 2. The existence of such exceptions is recognised by the section HG 2 wording of “unless the context requires otherwise”.
- 6.8 A qualifying company incorporated under the Companies Act 1993 will continue to be subject to the general regulatory requirements under the Companies Act and the Financial Reporting Act 1993 – for example, the requirement to file annual returns with the Companies Office.

Chapter 7

OTHER MATTERS

Qualifying company and shareholder are associated persons

- 7.1 Section YB 12 of the Income Tax Act treats a partnership and a partner in the partnership as associated persons. However, an exception exists for limited partners. A limited partnership and a limited partner in the partnership are associated persons only if the limited partner has a partnership share of 25 percent or more.
- 7.2 An ordinary company and a shareholder are associated persons if the shareholder has a voting interest of 25 percent or more in the company. This is consistent with the associated person rules for limited partnerships.
- 7.3 As a result of qualifying companies being treated as a partnership and their shareholders as partners for income tax purposes, section YB 12 would apply. Consequently, a qualifying company and its shareholders would always be treated as associated persons, regardless of whether the shareholder has an interest in the qualifying company of 25 percent or more. Even though the new qualifying company rules will be mainly based on the limited partnership rules, the application of section YB 12 is appropriate because a qualifying company is a closely held entity with the shareholders typically managing the company, which is not the case with limited partners.
- 7.4 For the disposal of film property, section DS 4(5) provides that an LAQC and an LAQC shareholder are associated persons. The removal of the LAQC regime and application of section YB 12 to qualifying companies and their shareholders will supersede section DS 4(5), which will be removed.

Anti-avoidance provisions

- 7.5 There are currently a number of specific anti-avoidance provisions relating to qualifying companies – in particular, those in sections GB 6 and HA 12 of the Income Tax Act.
- 7.6 Section GB 6 applies when a company share has been subject to an arrangement whose purpose is to defeat the intent and application of the qualifying company rules, and when this arrangement allows a company to enter into the qualifying company rules. In such cases, the company is treated as not being a qualifying company. Section HA 12 provides that an LAQC is considered to be not eligible to be an LAQC if a share in the company has been part of an arrangement whose purpose is to defeat the intent and application of the qualifying company rules.

- 7.7 Officials consider that the general anti-avoidance provision in section BG 1 should be sufficient to cater for the situations that sections GB 6 and HA 12 are intended to address. Therefore, it is proposed to remove these specific anti-avoidance provisions as part of this reform.

Goods and Services Tax Act 1985

- 7.8 Under the Income Tax Act, qualifying companies under the new rules will be treated as companies for the purposes of the Goods and Services Tax Act 1985, and the company would be the taxable person rather than the shareholders.

Chapter 8

TRANSITION

- 8.1 Existing qualifying companies which continue to meet the eligibility requirements will automatically transition into the new rules, and may not remain under the current rules.
- 8.2 If an existing qualifying company revokes its election into the qualifying company rules, ordinary company tax treatment will apply from the start of the income year in which the revocation notice is received by Inland Revenue, unless a later income year is nominated.
- 8.3 The flow-through tax treatment will apply for income years beginning on or after 1 April 2011. Qualifying companies with early balance dates will continue operating under the current rules until the start of their next income year after 1 April 2011.

Tax consequences of transition

- 8.4 There will be no deemed disposal and reacquisition of an existing qualifying company's assets when it transitions into the new qualifying company rules, in order to reduce the tax compliance costs of transition.
- 8.5 It is proposed that shareholders of qualifying companies that transition into the new treatment will need to determine their initial membership basis. The limited partnership rules have two methods for determining this, a market value method and an historical method. Similar methods may be appropriate for determining the initial membership basis for a transitioning qualifying company.

Existing carried-forward losses

- 8.6 When a company elects into the qualifying company rules, any loss balances which arose in the income years during which the company was not a qualifying company are forfeited. This includes attributed CFC losses and FIF losses. It is proposed to maintain this treatment under the new qualifying company rules.
- 8.7 Officials propose that any loss balances accumulated by an existing qualifying company (not also being an LAQC) will be allocated, under the new rules, to shareholders in the qualifying company based on their effective interest. These losses will only be allowed to be offset against the shareholder's income from that qualifying company.

Imputation credit account

- 8.8 A qualifying company under the new rules will not be able to maintain an imputation credit account (ICA) or other memorandum account. Any existing credits in an ICA or other memorandum account would be extinguished on the qualifying company's transition into the new rules. This is appropriate because, under the partnership model, there will be no separate taxable distribution from a qualifying company to its shareholders.

Qualifying company election tax

- 8.9 Under the current qualifying company rules, dividends paid by a qualifying company to its shareholders either have imputation credits and/or dividend withholding payment credits attached or are exempt from tax to the extent that the dividends are unimputed. Thus, it is necessary to tax the company's reserves at the time of entry into the qualifying company rules, as once the company is a qualifying company those reserves will subsequently be able to be distributed tax-free to the extent that dividends are unimputed.
- 8.10 The tax on these reserves is referred to as the qualifying company election tax (QCET), and is payable at the company tax rate. It is levied on an amount that is broadly equivalent to the amount which would be taxable if the company were to wind up. QCET prevents taxable reserves within a company being rendered exempt simply by electing into the qualifying company rules.
- 8.11 Under the new qualifying company rules, a company's reserves would be treated as being held by a shareholder in proportion to each shareholder's effective interest. The qualifying company would be treated as not holding the reserves. This will be achieved through the flow-through mechanisms in section HG 2 of the Income Tax Act.
- 8.12 A company's retained earnings that have not been subject to tax (that is, which are unimputed) will be attributable directly to shareholders when the company becomes a qualifying company. Therefore, there would be no taxable distribution when the company makes an actual distribution to its shareholders. Such amounts could still be distributed tax-free to shareholders. It is necessary, therefore, to retain a form of QCET to cater for situations when an ordinary company enters the qualifying company rules, to ensure unimputed retained earnings are taxed.
- 8.13 Owing to flow-through treatment, the qualifying company itself will not retain any reserves or be able to pay QCET on those reserves. It is proposed to amend the QCET rules in sections HA 40 to 42 of the Income Tax Act to make shareholders separately liable for QCET based on their share of the company's reserves when the company enters the qualifying company rules. A shareholder's portion of the company's reserves will be determined by their effective interest in the qualifying company. The values on which QCET is calculated will be reflected in the tax cost of revenue account property under the new qualifying company rules.

- 8.14 To determine a shareholder's personal liability for QCET, the current formula in section HA 41 will be adapted. QCET will be calculated on the company's reserves (which are allocated to shareholders) but will be paid by each shareholder at their tax rate in proportion to their effective interest in the company. This could be achieved by including the amount calculated before tax in each shareholder's return which, therefore, will be subject to ordinary income tax.