

Closely held company taxation issues

An officials' issues paper

September 2015

Prepared by Policy and Strategy, Inland Revenue, and the Treasury

First published in September 2015 by Policy and Strategy, Inland Revenue, PO Box 2198, Wellington 6140.

Closely held company taxation issues – an officials' issues paper.
ISBN 978-0-478-42416-4

CONTENTS

CHAPTER 1	Introduction	1
	Summary of suggested changes	2
	Next steps	4
	How to make a submission	4
CHAPTER 2	Framework for considering company taxation	7
	Introduction	7
	Policy framework for considering company taxation	7
	Target audience for the LTC rules	12
	Treatment of capital gains	12
CHAPTER 3	LTC entry criteria	15
	Introduction	15
	Current entry criteria	15
	Review of company requirements	16
	Review of shareholder requirements	17
CHAPTER 4	International aspects – foreign income and non-resident ownership	25
	Introduction	25
	Policy considerations	25
	Proposed approach	28
CHAPTER 5	Deduction limitation rule	29
	Introduction	29
	The current rule	30
	Problems with the current rule	32
	When excess deductions arise that might justify restrictions	33
	Partnerships of LTCs	35
	Transitional arrangements	36
	Technical changes to the deduction limitation rule	36
	Possible alternative rule	37
CHAPTER 6	Qualifying companies	39
	What should be done about those companies that remain as QCs?	39
	Proposed approach	39
CHAPTER 7	Transitioning into the LTC regime	41
	Introduction	41
	Entry formula	41
	QCs transitioning to LTCs	43
	Values at time of entry	43

CHAPTER 8	Debt remission	45
	Introduction	45
	Related parties debt remission in asymmetric situations	45
	Clarifying remission income on exiting the LTC rules	46
CHAPTER 9	Dividend simplification	49
	Introduction	49
	Tainted capital gains when capital asset sold to non-corporate associated person	49
	Tainted capital gains when capital asset owned by more than one company in a group of companies	51
	RWT compliance issues	51
	Cash and non-cash (taxable bonus) dividends	54
	Shareholder salaries	56
APPENDIX 1	Statistics	57
APPENDIX 2	Alternative deduction limitation rules	63

CHAPTER 1

Introduction

- 1.1 Closely held companies are companies with few shareholders. Such companies comprise a significant proportion of the approximately 400,000 companies¹ in New Zealand. Many of these companies use the general company tax rules to govern their interface with their shareholders. However, there are specific tax rules available for certain types of closely held companies.
- 1.2 Since the early 1990s very closely held companies had been able to pass capital gains and company losses through to shareholders by electing to become a qualifying company (QC) or a loss-attributing qualifying company (LAQC). In 2010 the Government announced major changes to those specific tax rules, essentially removing LAQCs, closing off the QC rules for new entities and providing a replacement option that enabled a closely held company to be treated as if it were a partnership. Under this new approach, a company's income and expenditure would be directly attributed to its owners in proportion to their interests, via the new look-through company (LTC) rules.
- 1.3 Transitional arrangements were provided to help QCs become LTCs. The government also undertook to review the dividend rules with a view to simplifying them for closely held companies more generally.
- 1.4 Since then, a range of concerns have been raised about the workability of the LTC rules, particularly for small businesses. This may be deterring companies from becoming LTCs as well as imposing additional compliance costs on those that become LTCs. At the end of the 2014 income year, although there were around 50,000 LTCs, there were also still nearly 70,000 QCs. While there are a range of reasons for a company continuing to be a QC, it should not be because the LTC rules are hard to comply with.
- 1.5 Accordingly, this issues paper reviews the LTC rules and suggests a range of changes to make the rules more workable. It also considers changes to the dividend rules applying to closely held companies that are neither LTCs nor QCs. Again this work is consistent with the Government's objective of simplifying tax requirements and reducing compliance costs for small and medium businesses.
- 1.6 The focus, however, has not been purely on simplification. Consideration has also been given to the fundamental policy approach to ensure that any changes that are recommended are consistent with wider tax policy frameworks and support the integrity of the tax system. The policy approach is outlined in Chapter 2 and includes consideration of the treatment of capital gains made by closely held companies.

¹ Based on companies filing tax returns.

- 1.7 Outside of liquidation, capital gains and other tax preferences² are clawed back when distributed by standard companies. In contrast, the LTC regime provides a vehicle for directly flowing through capital gains tax-free throughout the life of a company as LTCs are intended to be a genuine parallel to direct ownership. Extending this approach outside of LTCs raises complex issues that cannot be considered in isolation. It would therefore be premature to contemplate changes in these areas without significant further work, which could be handled through the standard tax work programme process at a future date. In the meantime, we consider it is important to proceed with the specific simplification initiatives proposed in this paper.
- 1.8 Some significant changes are being suggested. They include changes to the criteria that a company has to meet in order to qualify as a LTC, most notably in relation to trusts, the use of LTCs as a vehicle for conduit investment by non-residents and the requirement that the LTC have only one class of share. The changes would also narrow who would be covered by the restriction that limits an owner's LTC losses to the amount they have at risk (the deduction limitation rule). The changes are intended to better reflect the intended closely held nature of a LTC. A summary of the suggested changes is provided below. They are discussed in detail in the following chapters.
- 1.9 Some key statistics are provided in Appendix 1.

Summary of suggested changes

LTCs

Entry criteria

- Changes should be made in relation to trusts:
 - A beneficiary that has received any distribution in the last six years should be a “counted owner”.³
 - A company should not be eligible for LTC status if a trust that is a shareholder makes a distribution to a corporate (non-LTC) beneficiary.
 - The trustee should continue to be a single counted owner in the event that no distributions are made in the relevant period (last six years).
- Charities and Māori authorities would be precluded from being shareholders in LTCs or beneficiaries of trusts that own shares in LTCs. This would not impact on standard charitable donations.
- More than one class of share should be allowed so as to provide for different voting rights, provided all shares still have uniform entitlements to income and deductions.
- As a LTC is not intended as a conduit vehicle, its foreign income would be restricted to the greater of \$10,000 or 20 percent of its gross income when more than 50 percent of the LTC's shares are held by non-residents, if it wishes to retain its LTC status.

² Tax preferred income is income received by a company where New Zealand company tax is either lightly imposed, or not imposed at all.

³ Counted owners are the owners of the LTC. A LTC can have no more than five counted owners.

Deduction limitation rule

- The restriction that limits an owner's LTC deductions to the amount they have at risk should be confined to just situations when there are partnerships of LTCs.
- Some technical changes should be made to the formula to clarify its application for those still covered by the rule.
- Deductions that have had to be carried forward can be used as an immediate deduction against the shareholders' other income in the 2017–18 income year.
- The anti-avoidance valuation rule (in section GB 50) designed to ensure that partners' transactions are at market value should be extended to include LTC shareholders.

Existing QCs

- Existing QCs should be allowed to continue but, to address concerns that they could be sold for a windfall gain, they would lose their QC status upon change of control of the company.

Remission income

- There should not be remission income for a shareholder when an amount owed to them by the LTC is subsequently remitted because the LTC cannot repay the loan.
- There should be a legislative technical fix to ensure that the remission income rules apply as intended when a debt is remitted by a third party, to clarify the value of a loan that is impaired.

Entry matters

- The income adjustment done at the time of entering into the LTC regime (the untaxed reserves formula), should be changed to ensure that the income adjustment reflects shareholders' marginal tax rates rather than the company rate of 28%.
- A technical change should be made to clarify the values at which a LTC's assets and liabilities are deemed to be held by LTC owners on the company entering the regime.

Initiatives to simplify and reduce the compliance and administration costs associated with closely held companies that are neither LTCs nor QCs

- Liberalisation of the restrictions around tainted⁴ capital gains to ensure that genuine capital gains made by small businesses do not become taxable on liquidation merely because there is a transaction involving an associated party. Tainting would not apply when the associated person is a non-corporate and we are considering whether there are other cases when it should not apply.
- The deduction of RWT from fully imputed dividends between companies would be optional rather than obligatory. This would be of benefit to a wide range of companies.
- Optional removal of resident withholding tax (RWT) obligations from small companies in respect of the dividends and interest they pay to their shareholders would be considered as part of the wider work on streamlining business tax processes.
- Streamlining RWT obligations when cash and non-cash dividends are paid concurrently so that they can be treated as a single dividend.
- Shareholder salaries could be subject to a combination of PAYE and provisional tax provided the company maintains the approach consistently from year to year.

Next steps

- 1.10 Once the consultation period has closed, officials will report to the Government on the feedback and the Government will consider what legislative changes are appropriate. Such changes are intended to be included in the next omnibus taxation bill, with most of the changes applying from the beginning of the 2017–18 income year.

How to make a submission

- 1.11 You are invited to make a submission on the proposed reforms and points raised in this issues paper. Submissions should be addressed to:

Closely held company taxation issues
C/- Deputy Commissioner, Policy and Strategy
Policy and Strategy Division
Inland Revenue
PO Box 2198
Wellington 6140

Or email policy.webmaster@ird.govt.nz with “Closely held company taxation issues” in the subject line. Electronic submissions are encouraged.

⁴ Capital gains become “tainted” gains when a company sells a capital asset to a person or entity which is a related person. Tainted gains are taxable in the hands of shareholders.

- 1.12 The closing date for submissions is 16 October 2015.
- 1.13 Submissions should include a brief summary of major points and recommendations. They should also indicate whether the authors would be happy to be contacted by officials to discuss the points raised, if required.
- 1.14 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. 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

Framework for considering company taxation

Introduction

- 2.1 In reviewing the various aspects of the LTC rules we have considered how they fit within the desired policy framework for entity taxation. Accordingly, before discussing our suggested changes, we outline the policy framework below.

Policy framework for considering company taxation

- 2.2 A business can be run in a variety of different ways – as a sole trader, a partnership, a trust, or a company. Likewise, the tax treatment can vary in practice depending on the entity used to conduct the business.
- 2.3 The tax system contains a number of flow-through entities including LTCs, ordinary partnerships and limited partnerships, as well as quasi flow-through entities, such as trusts, grand-parented QCs and portfolio investment entities (PIEs). The entities sometimes parallel commercial law and in other cases have been introduced into the tax law to achieve particular policy purposes. A comparison of the various entity treatments is provided in Table 1.
- 2.4 Having a variety of treatments can create economic distortions. Accordingly, it is desirable to minimise the areas of difference.⁵ However, having a single tax treatment for all business entities is impractical.⁶ Therefore, we see a minimum of at least two types of tax treatment: the individual and the standard company tax approaches.

Individual taxation approach

- 2.5 Under this approach, all the net income is attributed to the underlying individuals and is taxed at their marginal tax rates. If certain forms of income derived by the business are free of tax, the individuals receive the income tax-free. If losses are generated within the business, the losses can be used to reduce tax on the other income of the individuals, or can be carried forward by them. When the individual sells all or part of their interest in the business, it can trigger tax consequences such as claw-back of depreciation.

⁵ In designing the appropriate tax treatment for entities, and in particular closely held companies, some key issues are:

- when to allow tax preferences generated by an entity to flow through to the owners of the entity;
- if tax preferences are allowed to flow through, should there be restrictions on the ability to earn offshore income because when an ordinary company earns tax preferred offshore income this preference is clawed back on distribution; and
- how to treat losses, and to ensure that only true economic losses are deductible.

⁶ One tax treatment for all entities would require a fully integrated company tax system whereby company profits are attributed to shareholders and taxed directly in their hands in a similar way to the profits of a partnership being taxed in the hands of the partners. Full integration was rejected as an option in the mid-1980s and we would not recommend revisiting this issue.

Table 1: Comparison of entity tax treatments

	Direct ownership	General partnership	Limited partnership	LTC	LAQC (no longer available)⁷	QC	Trust	Company
Ownership rules	N/A	No restrictions	No upper limit on number of partners but must have at least one general partner, and one limited partner	Five or fewer look-through owners (under review)	Was five or fewer shareholders including associates	No new QCs allowed Existing QCs must have five or fewer shareholders including associates	No restrictions on settlors or beneficiaries	No restrictions
Different ownership rules / class of shares	N/A	Partnership agreement could provide for different rights for different partners	Partnership agreement could provide for different rights for different partners	Only one class of share allowed	Multiple classes of shares allowed	Multiple classes of shares allowed	Trust agreement could provide for different rights for different beneficiaries	Multiple classes of shares allowed
Owner's liability	Unlimited	Unlimited	Limited	Limited	Limited	Limited	Limited for beneficiaries, unlimited for trustees	Limited
Tax rate	Owner's tax rate	Partners' tax rates	Partners' tax rates	Shareholders' tax rates	Company tax rate on accrual, adjusted to shareholders' tax rates on distribution	Company tax rate on accrual, adjusted to shareholders' tax rates on distribution	Trustee income taxed at equivalent to top personal rate, beneficiary income taxed at beneficiaries' tax rates	Company tax rate on accrual, adjusted to shareholders' tax rates on distribution
Losses	Available to owner	Available to partners	Available to partners subject to loss limitation rules	Available to shareholders subject to loss limitation rules (under review)	Available to shareholders	Quarantined to company	Quarantined to trust	Quarantined to company
Capital gains	Never taxed	Never taxed	Never taxed	Never taxed	Never taxed	Never taxed	Never taxed	Not taxed on accrual, may be taxed on distribution
Ownership changes / restructures	Owner taxed on revenue account gains / losses and depreciation adjustments	Partners taxed on share of revenue account gains / losses and depreciation adjustments subject to de minimis rules	Partners taxed on share of revenue account gains / losses and depreciation adjustments subject to de minimis rules	Shareholders taxed on share of revenue account gains / losses and depreciation adjustments subject to de minimis rules	Not taxed (unless shareholder holds shares on revenue account)	Not taxed (unless shareholder holds shares on revenue account)	Not taxed (beneficiaries' rights could be changed by varying trust agreement)	Not taxed (unless shares are held on revenue account) Shareholder continuity requirements apply – if breached, losses and imputation credits are forfeited

⁷ Loss attributing qualifying companies (LAQCs) were a form of QC that enabled losses to flow through to shareholders. Most QCs (around 95 percent) were LAQCs. As Table 9 in Appendix 1 shows, around half of LAQCs have retained their QC status, around a third have become LTCs while the rest are either carrying on business in another form (for example, as an ordinary company) or have ceased business.

- 2.6 This approach applies not only to individuals but also to partnerships⁸ and LTCs as they are closely controlled by individuals. In their case, the income earned and the expenditure incurred by the company are allocated to the partners and shareholders on the basis of their respective ownership. The LTC rules allow the business to still have the commercial benefits of a company, such as limited liability and the ability to contract in its own right. Conceptually, this type of integration is ideal for closely held companies as it meets one of the goals of closely held company taxation, which is to reduce the tax impediments and/or unintended benefits of migration from an unincorporated business to a business carried on in a company. That is, the tax consequences should be similar regardless of the form in which the business is run. However, a number of practical constraints limit its desirability as a tax vehicle for all small to medium sized companies.

Standard company taxation approach

- 2.7 The second main approach is company taxation. The company is taxed on the income it earns. When company profits are distributed as dividends to shareholders, imputation credits can be attached as a credit for the tax paid at the company level, to ensure that there is no double taxation.
- 2.8 Under this approach, if a company earns lightly taxed or tax-free income, this tax preference is clawed back when dividends are paid because there are no corresponding imputation credits. Two key examples of preferences that are clawed back are controlled foreign company (CFC) dividends which are exempt at the company level, and capital gains made by the company. Under standard company tax treatment, capital gains can only be distributed tax-free to shareholders on the liquidation of the company. This aspect is discussed in more detail later in this chapter.
- 2.9 Also under standard company taxation, losses of a company must be carried forward to be offset against future company income and cannot be used by the shareholders to offset against their other income. When a shareholder sells their shares in the business or new owners are introduced, in many cases it does not trigger tax consequences.
- 2.10 Examples comparing the individual and company approaches are provided below in Table 2.

⁸ For tax purposes a partnership includes not only relationships covered by the Partnership Act 1908 but also certain joint ventures and the co-ownership of property.

Table 2: Examples comparing individual and company treatment

	Individual treatment	Standard company treatment (simplified to ignore RWT)
Taxable income	An individual earns \$100 of taxable income. This is taxed at their marginal tax rate (33% in this case), which means that the tax is \$33.	<p>The individual is the sole shareholder in company A. Company A earns \$100. This is taxed at the company tax rate of 28%, making the tax \$28.</p> <p>The company distributes the balance of \$72 as a dividend, with \$28 in imputation credits attached, making a gross dividend of \$100.</p> <p>The shareholder includes the \$100 dividend in their taxable income and a further \$5 of tax is payable after allowing for the \$28 imputation credits.</p> <p>Overall, there is no double taxation and the tax is based on the individual's tax rate.</p> <p>Note that if the shareholder is on a marginal tax rate of 17.5%, the tax liability on the \$100 dividend is \$17.50, so that the balance of the imputation credits (\$28 - \$17.50) can be used towards meeting the tax on other income.</p>
Capital gain	An individual earns \$100 in capital gains (say on the sale of land). This does not form part of the individual's income and no tax is payable.	<p>If a company earns a capital gain of \$100, there is no company tax.</p> <p>If it distributes the \$100 as a dividend there would be no imputation credits to attach.</p> <p>The individual shareholder includes the \$100 dividend in their taxable income and has \$33 tax to pay.</p> <p>This means that under the company treatment, capital gains made at the company level are clawed back on distribution to shareholders (except where the company liquidates).</p>
Losses	An individual makes a tax loss of \$100 on an income earning asset (say a rental property). This loss can be offset against the individual's other income, or carried forward to offset against future income.	<p>A company makes a tax loss of \$100.</p> <p>This loss can be offset against the company's other income (if any) or can be carried forward to offset against future company income.</p> <p>The loss cannot be distributed to shareholders, but it can be offset to other group companies.</p>

Mixture of the two approaches

- 2.11 As Table 1 illustrates, for some types of entity the income tax treatment is a mixture of the above two approaches. For example, under the QC rules profits are taxed at the standard company tax rate with any subsequent distribution of those profits being taxable at the respective shareholders' tax rates (with imputation credits attached), but with capital gains and any other untaxed amounts being able to be passed through to shareholders tax-free. Previously, LAQC losses could also be passed through to shareholders to offset against any other income they earned.
- 2.12 When the company and top personal tax rates were aligned, this mixed approach was generally appropriate. However, once the top personal rate became higher than the company rate there was concern that the QC/LAQC regime went beyond the objective of removing the tax disadvantage from incorporation,⁹ and in fact provided a tax advantage.¹⁰
- 2.13 The treatment of trusts is also a hybrid, with the income earned being either taxed as trustee income at equivalent to the top personal rate or, if distributed, taxed at the personal tax rates of the beneficiaries. Losses are quarantined within the trust, to be used against future trustee income.

Boundary between the approaches

- 2.14 Having two different tax treatments will always create some distortions. It raises the question about where the line should best be drawn between them. There is no perfect solution to this question so a degree of pragmatism is required, while trying to minimise likely distortions. Since LTCs (and QCs) sit on this boundary (a LTC being legally a company but with individual flow-through tax treatment) it is important to know the target audience for the LTC rules as this influences the criteria that are applied to LTCs.
- 2.15 Individual treatment should be applied to company situations when the investment could have genuinely been owned directly by the individual or family trust shareholder(s) but they wish to have the protection of limited liability. This prevents tax being a distorting factor in what would otherwise be a commercial decision to incorporate.
- 2.16 Allowing the pass-through of losses also raises the possibility of loss trading.¹¹ As a matter of policy the eligibility criteria are an important way of reducing the possibility of such trading. Focusing on the number of shareholders seems a useful method of reducing this risk. It is also consistent with the approach that LTCs are only intended for investors who have a realistic option of operating as individuals or through a company.

⁹ This was compared with the treatment as a sole trader or partnership.

¹⁰ The non-alignment of the company tax rate and top personal rate provided a potential incentive to defer distributing a QC's taxable income to shareholders on personal rates above the company rate, whereas losses could be automatically passed through to those shareholders to be offset against their other income.

¹¹ Loss trading occurs when an arrangement is made whereby taxpayer(s) who do not hold an economic interest in an entity, such as a LTC, that has made a tax loss are able to deduct the loss against their other income. The arrangement is invariably tax driven rather than related to any wider commercial return. The government loses revenue as a result of the sheltering of the income of the unrelated taxpayer(s).

- 2.17 A subsequent question is whether this individual treatment approach should apply to companies operating cross-border. In terms of outbound investment, there is a policy case for applying corporate treatment to most, if not all, overseas businesses owned either directly (branches) or indirectly (CFCs) by New Zealand companies, in order to better align the treatment of cross-border investments in different forms. This raises the issue of whether it is consistent to allow outbound investment to receive look-through tax treatment. On the other hand, there is the general point that LTC taxation is intended to be similar to the taxation of direct investment by shareholders.¹²
- 2.18 There is also the general issue with conduit investment and, consequently, the related risks to the tax base and base erosion and profit shifting (BEPS) concerns. These international aspects are discussed in Chapter 4.

Target audience for the LTC rules

- 2.19 What does this boundary imply for the target audience for the LTC rules? Our conclusion is that the LTC target audience is any investment that can be done by an individual or small group of individuals. This means the focus is on tight control of the entity by individuals rather than on the size of the entity, even though in practice small unsophisticated businesses are likely to make up the majority of LTCs. As Chart 1 illustrates later in Chapter 5, the majority of LTCs fall into the -\$20,000 to +\$10,000 annual income range and 90 percent are within the -\$50,000 to +\$50,000 annual income range.

Treatment of capital gains

- 2.20 We have concentrated our review primarily on streamlining the rules for LTCs. However, a number of issues with the current wider policy settings have been raised by stakeholders, including the extent to which closely held companies should be able to distribute capital gains tax-free.
- 2.21 There is a case for allowing capital gains to flow through tax-free in certain circumstances when there is a genuine parallel to direct ownership. This is because those gains would be tax-free if earned directly (or through a partnership) by the owner. Similar considerations were behind the Valabh Committee recommending the QC regime in the early 1990s.¹³ Like QCs, the LTC regime provides a vehicle for capital gains to be distributed tax-free throughout the life of a company, not just on liquidation.
- 2.22 Issues such as whether to allow closely held companies outside of LTCs and existing QCs to distribute capital gains tax-free during the course of business are complex and cannot be considered in isolation. It would be premature to contemplate changes in these areas without significant further work, which

¹² Although typically individuals do not carry on overseas business through branches and do not very often carry out business through directly owned CFCs.

¹³ The Valabh Committee favoured the qualifying company approach over directly attributing the income and expenditure of closely held companies to individual shareholders because they considered that it would be simpler and cover a potentially wider group given that some companies would have more than one class of share.

could be handled through the standard tax policy work programme process at a future date.

- 2.23 To illustrate their complexity, we note that the issue of the tax status of capital gain distributions is intricately tied up with the tax treatment of dividends. Dividends can be classified as distributions from revenue reserves and distributions from capital sources. If only certain types of dividend were exempt, such as those paid out of capital profits, there would be pressure to convert company income into the preferred form. Refraining from permitting the pass-through of tax preferences therefore helps to ensure the robustness of the company tax base.¹⁴ Similar considerations apply to limit a company's ability to return capital to ensure that what is in effect a dividend from retained earnings is not "dressed up" as a return of capital.
- 2.24 The tax treatment of capital gains on liquidation provides a further complication. In practice, businesses can distribute capital gains tax-free through forming multiple companies to hold specific assets and liquidating those companies as the capital gains on the assets are realised. In doing so, however, they incur additional compliance costs. We acknowledge the compliance cost concerns but arguably the ability to get out capital gains tax-free on liquidation is a distortion, at least for those companies for whom company tax-treatment is appropriate.

¹⁴ The taxation of capital gains was suggested even on liquidation in the Government *Consultative Document on Full Imputation* (December 1987) but was recommended against by the subsequent Consultative Committee (see *Full Imputation – Report of the Consultative Committee* (April 1988)).

CHAPTER 3

LTC entry criteria

Introduction

- 3.1 A set of entry criteria apply to limit the type of entity that can be a LTC and to limit the type and number of owners. Given that flow-through treatment includes the flow-through of losses, the entry criteria also help to limit the opportunity for those losses to be traded or otherwise utilised by those not incurring the economic loss.
- 3.2 A key consideration of the review has been whether these entry criteria sufficiently match the intent of the LTC regime as designed for closely controlled companies.

Current entry criteria

- 3.3 We have reviewed the entry criteria against the “target audience” for the LTC regime, namely, investments that could otherwise be made by an individual or small group of individuals, including through a family trust. Other tax-transparent options are available for more widely held investments and, given their different target audience, we do not see the availability of such options as a reason for widening the eligibility criteria for LTCs.
- 3.4 For example, given that more widely held vehicles such as limited partnerships open up the possibility for loss retailing,¹⁵ it is appropriate that the tax legislation applies a deduction limitation rule in their case to limit the pass through of deductions to the amounts that owners have at risk. In contrast, this issues paper is recommending (see the next chapter for more detail) that the pass-through of deductions be retained for LTCs and that a deduction limitation rule should not be applied to most LTCs. In these circumstances, it is even more important that widely held investments cannot access LTC treatment.
- 3.5 Table 3 summarises the current entry criteria for LTCs and QCs. The QC rules are used only as a point of comparison. We are not proposing changing the current eligibility rules for QCs, which is consistent with the grandparenting of those entities.
- 3.6 In comparison, as noted in Table 1, the tax rules for a partnership contain no comparable entry criteria, and a limited partnership’s main entry restrictions are that it has to have at least one general partner and a limited partner. General partners manage the business and are liable for the debts and obligations of the partnership, whereas limited partners are usually passive investors and are only liable to the extent of their capital contribution. This distinction is akin to directors and shareholders in a company.

¹⁵ Loss retailing is a form of loss trading. It occurs when schemes are marketed to portfolio investors which produce significant upfront tax deductions to be applied against the investors’ other income. Those losses typically exceed the amounts at risk.

Table 3: Entry criteria

LTC	QC
<p>Company requirements/restrictions:</p> <ul style="list-style-type: none"> • Has to be “company” • Cannot be flat-owning company • Is tax resident in NZ, including under double tax agreements • One class of share • No restrictions on earning foreign income <p>Shareholder requirements:</p> <ul style="list-style-type: none"> • Maximum of five look-through counted owners • Shareholders must be natural persons, trustees (natural persons or corporate) or another LTC • Can be non-resident • Natural persons linked to two degrees counted as one • Generally look behind trustees to beneficiaries (provided they have received distributions of beneficiary income in the last three income years – where all the income has not been distributed, the trustees are counted as owners) • Look behind LTC shareholders to the ultimate owners 	<p>Company requirements/restrictions:</p> <ul style="list-style-type: none"> • Has to be a “company” • Is tax resident in NZ, including under double tax agreements • Cannot earn more than \$10,000 p.a. of non-dividend foreign income • Cannot be part of an arrangement, the purpose of which is to defeat intent and application of rules (section GB 6) <p>Shareholder requirements:</p> <ul style="list-style-type: none"> • Maximum of five look-through shareholders • Shareholders must be natural persons, trustees (natural persons or corporate) or another QC • Can be non-resident • Natural persons linked to one degree counted as one • Look behind trustees to beneficiaries (counting all beneficiaries who have received dividends from the QC through the trust as beneficiary income since the 1991–92 income year) • Look behind QCs to their ultimate owners

Review of company requirements

“Company” and tax resident status requirements

- 3.7 The LTC rules are designed to allow flow-through tax treatment to businesses that have a genuine reason for choosing limited liability corporate structures as an alternative to undertaking their activities as sole traders or as small partnerships. The requirement that the business be a “company” is, therefore, an integral part of the rules.
- 3.8 Likewise, given that effective look-through treatment is targeted at closely controlled New Zealand businesses, the requirement that the company be New Zealand tax resident is also appropriate.

One class of share

- 3.9 Currently a LTC can only have one class of share. This restriction is an important part of look-through treatment as it makes for ease of calculating relative shareholdings, which provides the basis for allocating a LTC’s income and losses. Shareholding is likely to represent a person’s contribution to a family business or a conscious decision on the part of those with interests in a company to divide the profits of a business in particular proportions. Investors in a LTC can achieve different risk profiles through the use of debt and equity, as appropriate.

- 3.10 We acknowledge that there can be legitimate commercial/generational planning reasons for shares to carry different voting rights and that the current restriction may inhibit some companies from becoming LTCs. A parent, for example, because of their industry expertise, may want to retain control of the decision-making process when children are introduced into the business.
- 3.11 In these circumstances, we consider that the “one class of share” requirement may be unnecessarily rigid. However, we remain concerned about types of shares that could produce income or deduction streaming opportunities.
- 3.12 As a result, we are recommending that different classes of shares carrying different voting rights be allowed, provided all other rights are the same. In particular, the shares must carry the same rights to income and losses, including on liquidation.

Foreign income and non-resident ownership

- 3.13 These aspects are discussed separately in Chapter 4.

Review of shareholder requirements

Maximum of five look-through counted owners

- 3.14 The purpose of the requirement that a LTC must have five or fewer “look-through counted owners” is to ensure that the company should be “closely controlled” by individuals. This is consistent with the idea that LTCs are a substitute for direct investment. Under the current rules:
- owners that are “relatives” are counted together;
 - LTCs that own shares in other LTCs are effectively ignored, with the owners of the parent LTC being instead counted for the purposes of the five-person test;
 - ordinary companies cannot directly hold shares in a LTC, but can indirectly have an interest in a LTC through receiving beneficiary income from a trust that owns shares in a LTC (a shareholding trust). In the latter case, the ordinary company’s shareholders (and those that hold market value interests) are counted as look-through owners when they have received beneficiary income in either the current year or one of the last three years;
 - similarly, natural person beneficiaries of a shareholding trust are only counted if they have received beneficiary income in the current year or one of the last three years; and
 - a trustee of a shareholding trust is treated as a counted owner if it has not distributed, as beneficiary income, all income attributed from the LTC interest in the current and last three years.

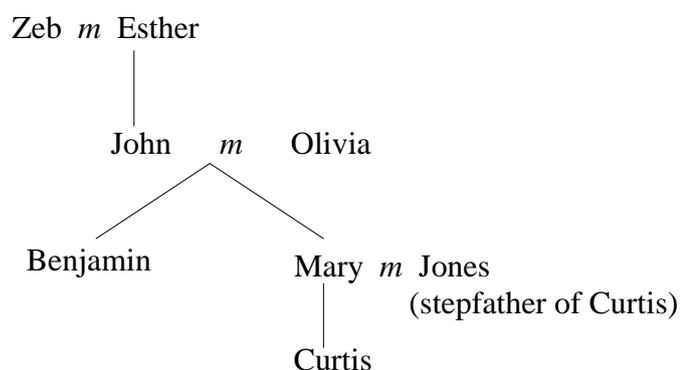
Relatives

3.15 To be a “relative”, a person must meet the general “associated persons” test in the tax legislation. Generally speaking, two people are related if they are:

- within the second degree of blood relationship with each other;
- in a marriage, civil union or de facto relationship with each other;
- in a marriage, civil union or de facto relationship with a person within the second degree of blood relationship;
- an adopted child of a person and persons within the first degree of relationship of that person;
- a trustee of a trust under which a relative has benefitted or is eligible to benefit.

3.16 The LTC rules also provide that dissolution of marriage, civil unions or relationships are to be ignored.

3.17 This current test can mean that significant family groups are counted together as a single LTC owner. In the following example¹⁶ (where there is a maximum of two children per couple), if all the people mentioned owned shares in the same LTC they would be counted as one person:



3.18 The current rules, therefore, contemplate situations when up to conceivably five multi-generational families could all be shareholders in a company and that company would still be eligible for LTC status. By contrast, the QC rules, which only allow one degree of relationship, are in theory more restrictive. In practice, however, there is no evidence that this difference is leading to significantly wider overall shareholdings. Most LTCs have only one or two shareholders/owners.¹⁷ The current test also has the benefit of being well understood given it is based on the definition of “associated person”.

¹⁶ See *Tax Information Bulletin* Vol. 23, No. 1, February 2011.

¹⁷ Of the 46,025 LTCs that filed an IR7L for 2013, 30 percent reported having just one ‘owner’ while 92.5 percent reported having either one or two ‘owners’. This seems to be largely in line with data on closely held companies more generally. A 2006 study on closely held companies indicated that of the 431,000 companies registered at the Companies Office, nearly 95 percent had five or fewer shareholders, with 140,000 having only one shareholder (33 percent of all companies) 186,000 having two shareholders (43 percent) and 80,000 having three to five shareholders (18 percent). See M. Farrington *A Closely held Companies Act for New Zealand*, submitted as part of the LLM programme at Victoria University of Wellington, (2007) 38 VUWLR.

- 3.19 Consequently, we are not proposing any changes in this area. Individuals would, therefore, continue to be treated as they are now, in other words a two degree of relationship test would continue to apply.

Companies

- 3.20 At present the only corporate that is permitted to have a direct shareholding in a LTC is another LTC (other than corporate trustees, which are discussed below). We are not recommending any changes in this area. The prohibition on ordinary companies owning LTC shares appears consistent with the idea that LTCs should not be widely held or used as a way to shelter company income from tax,¹⁸ and should be retained.

Trusts

- 3.21 Our starting proposition in looking at trustees as shareholders of LTCs is that the entry criteria tests would have failed if the interposing of a shareholding trust allows for more owners than would have been allowed if those people had held shares directly. In saying this, it is more challenging to determine who has “benefitted” from a LTC in a trust situation. We accept it is difficult to argue that all beneficiaries will always benefit from the fact that trustees own a LTC.
- 3.22 Nevertheless, we are proposing changes to how trusts are measured as “look-through counted owners” because the current rules seem to be too generous in two key respects.
- 3.23 The first issue is in relation to the measurement period. The current test that casts back just three preceding years when considering whether a beneficiary of a trust should be counted as a look-through counted owner potentially provides scope for beneficiaries to be ‘rotated’. The rotation of beneficiaries enables the profits of the company to be distributed to a larger beneficiary class while still meeting the requirement of a maximum of five look-through counted owners.
- 3.24 The second issue is the focus just on distributions of beneficiary income from LTC interests. The focus on beneficiary income is a proxy for receiving a benefit. However, there are instances when a person does not receive beneficiary income, but nevertheless benefits from a trust owning LTC shares. A person might, for example, receive a distribution of trustee income. It is not difficult to envisage situations when multiple beneficiaries could receive distributions of trustee income such that the numbers could be skewed.

¹⁸ For example, by taking a shareholding in a LTC, a LTC loss could be passed through to the company and used to shelter company income from tax, without the company incurring the underlying economic loss.

Example

Distributions of income from a LTC interest are made by Family Trust to 10 beneficiaries. The trustee is deciding on whether the trust's current year income should be made as trustee income or beneficiary income. Depending on the decision, the outcome in terms of the number of look-through counted owners can vary from 1 to 11.

- 3.25 Furthermore, the focus on income derived just from a LTC interest may cause practical difficulties given the fungibility of money and the potential for streaming distributions to selected beneficiaries.
- 3.26 We note that a more restrictive test applies to QCs – in their case a trustee must distribute all dividends from the QC as beneficiary income (other than non-cash dividends). Furthermore, all beneficiaries that have derived beneficiary income from dividends since the 1991–92 income year, when QCs were introduced, are treated as counted shareholders. This reference back to 1991–92 has proved to be a compliance problem in some instances, as time has elapsed.

The proposal

- 3.27 We are not suggesting adopting the QC approach but rather to count all distributions made, whether beneficiary or trustee income, corpus or capital. In terms of the time period, a LTC test that tied in with other more general record-keeping period requirements would appear to be justifiable. The proposal is that a beneficiary that has received any distribution from the shareholding trust in the last six years would be a counted owner.
- 3.28 This six year measurement period acknowledges that any extended period would need to be enforceable in practice and that imposing stricter than usual record-keeping requirements on trustees of relatively unsophisticated trusts would be difficult to justify. Rather than tying the LTC requirement to the record-keeping period required for tax purposes, it seems more appropriate to match the time period with that generally applying to claims under the Limitations Act 2010 as trustees are required to keep records for at least that time in case a beneficiary challenges a distribution decision.¹⁹
- 3.29 Some entities are likely to lose their LTC status as a result of this proposal. This is an appropriate outcome as it ensures that the LTC ownership rules in relation to trusts do not allow more look-through owners than would be the case under direct ownership.

When there are no distributions

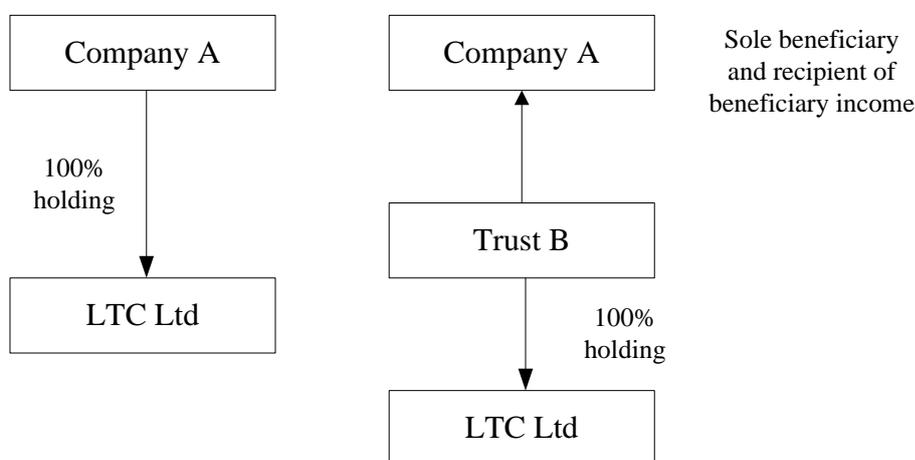
- 3.30 Currently, in the event that not all income from an interest in a LTC is distributed as beneficiary income, the trustee is a single counted owner. The only viable alternative to counting trustees in these circumstances would be to count settlors, on the assumption that they are the ones ultimately

¹⁹ The purpose of the Limitations Act is to promote greater certainty by preventing claims being brought against a person or business after a period of time (generally six years), but at the same time the business has to keep records for that period so that the relevant information is available should a claim be brought within that time period.

benefitting from the existence of the trust. However, a settlor test would likely be complicated,²⁰ and not a test that domestic trusts would be likely to have to apply commonly in their day-to-day management of their tax affairs. Consequently, our conclusion is that a trustee should continue to be a separate counted owner in the event that not all income is distributed for the relevant period. As with the proposed revised test for measuring the number of beneficiaries, the test for determining whether a trustee is a counted owner should be modified to focus on all income sources rather than just income from interests in LTCs.

Corporate beneficiaries

3.31 Corporate beneficiaries are currently permitted. This means that although the structure below on the left is prohibited, the one on the right is permissible. The effect of the two structures appears, however, to be identical:



3.32 It should, however, be noted that if the trust makes a distribution of beneficiary income from LTC interests to the corporate, the corporate is looked through when determining the number of owners. If it is widely held, then LTC status would be revoked.

3.33 In keeping with the exclusion of corporate shareholders, a company should not, in principle, be eligible for LTC status if a trustee shareholder has a corporate (non-LTC) beneficiary. Given, however, that a number of LTCs may already have corporate beneficiaries, we are proposing that the requirement focus on distributions to corporate beneficiaries. The proposal is that LTC status would cease from the beginning of the income year in which a distribution is made to a corporate beneficiary, irrespective of the number of natural person shareholders that it may have.

²⁰ For example, there may not be robust records around all situations when a person might have become a deemed settlor for tax purposes.

Example

XYZ Trust owns shares in ABC Limited (a LTC) and makes a distribution of 2016–17 year income to Corporate Limited (a beneficiary of the trust that is not a LTC) in the 2017–18 income year. LTC status would cease from the beginning of the 2017–18 income year.

- 3.34 In the above example, LTC status is lost in the year of the distribution. Ideally, if the distribution is from beneficiary income, then LTC status should be lost in the year that the beneficiary income is earned, which in the above example would be the 2016–17 income year. Because this would involve additional compliance costs in adjusting past tax payments and returns, we prefer to treat all distributions the same and to base the loss of status on the year of the distribution.

Other shareholders/beneficiaries

- 3.35 The above approach of looking through to the ultimate beneficiaries should extend to charities and Māori authorities given they are likely to have a wide set of beneficiaries.

Charities

- 3.36 Although not all charities are trusts, they nevertheless have to be carrying out a charitable purpose.²¹ Most also have to meet a public benefit test, which implies that they need to have far more than five beneficiaries. In these circumstances, rather than focusing on whether the charity is a trust, whether and when distributions have been made and whether there are more than five beneficiaries, it seems simpler, from a compliance perspective, to treat all charities the same. The proposal is to exclude charities from being either shareholders in a LTC or beneficiaries of a shareholding trust. This would not preclude charities from operating through other business structures.
- 3.37 LTCs or shareholding trusts may wish to alternatively make charitable donations. Generally, we do not consider that such charitable donations made in the normal course of business would be a problem. The only concern would be when regular donations were used as a proxy for LTC ownership. Given that we do not want to discourage genuine charitable donations, we consider that there may be merit in having an explicit safe-harbour rule to provide greater certainty. The rule would in effect allow a shareholding trust to donate up to 10 percent of the net income it receives from its look-through interest in any given year to charitable entities without bringing into question the status of the LTC.

²¹ The definition of “charitable purpose” in the Income Tax Act reflects general charities law, which is that the purpose has to be one of the following: the relief of poverty, the advancement of education or religion, or any other matter beneficial to the community. These purposes are commonly referred to as the four “heads” of charity. Except in the case of the relief of poverty, the public benefit test must also be satisfied. That test is that those benefiting must be the public or an appreciably significant section of the public.

Māori authorities

- 3.38 Māori authorities similarly have a wide number of beneficiaries and, therefore, should also automatically be precluded from being shareholders in a LTC, either directly or indirectly. An implication would be that a Māori authority's separate corporate business activity would be taxed at the standard company rate of 28%, as intended, rather than at the Māori authority rate of 17.5%.
- 3.39 Our understanding is that these proposed restrictions would not have a significant impact on either charities or Māori authorities, but feedback on this point is invited.

CHAPTER 4

International aspects – foreign income and non-resident ownership

Introduction

- 4.1 Currently there is no restriction on foreign investments by LTCs or on a LTC having non-resident shareholders. A LTC can earn foreign income and, unlike a QC, is not restricted to earning a maximum of \$10,000 non-dividend foreign income.
- 4.2 This open approach raises several policy issues:
- it allows LTCs to be used to avoid the features of the imputation system that apply to foreign income and allows branch losses to be applied against individual income; and
 - it provides a relatively low-cost conduit structure for non-residents to utilise.
- 4.3 The issue of whether LTCs should be used as a vehicle for cross-border investment has not been closely examined from a policy perspective before. A key aspect to consider is whether the rules for LTCs in respect of cross-border investment are consistent with the general policies underpinning New Zealand's international tax rules more generally. There are also some concerns that LTCs could be used as part of a conduit arrangement.

Policy considerations

- 4.4 There are three scenarios in the international context:
- A non-resident investing in New Zealand assets through a LTC.
 - A New Zealand resident investing offshore through a LTC.
 - A LTC owned by a non-resident with only foreign assets (the conduit case).

A non-resident investing in New Zealand assets through a LTC

- 4.5 In respect of the first scenario, flow-through treatment means that the non-resident owner of the LTC will be taxed only on their New Zealand-sourced income. Source taxation may also be reduced or eliminated under New Zealand's double tax agreements.
- 4.6 In this context hybrid entity mismatches where an entity is treated as flow-through in one country but not in another, which could be the case with LTCs,²² are under scrutiny by the OECD as part of its work on base erosion

²² For example, a LTC is a look-through vehicle in New Zealand but is treated as a company for tax purposes in Australia.

and profit shifting (BEPS). The OECD is developing recommendations for domestic rules intended to neutralise the tax effect of hybrid mismatches and New Zealand is looking at the suitability of implementing these recommendations.

A New Zealand resident investing offshore through a LTC

- 4.7 As discussed earlier, LTCs are designed for investments that would be made by an individual or small group of individuals, including through a family trust, but for the fact that the investors decide on a limited liability structure. This prevents tax being a distorting factor in what would otherwise be a commercial decision to incorporate. This distortion is less obvious when it comes to some forms of outbound investment. In many situations, making a significant outbound active investment, which typically is of a more significant scale, without the protection of a limited liability structure for the offshore investment would not be commercially realistic.
- 4.8 The QC regime requires that a company cannot earn more than \$10,000 a year of non-dividend foreign income. The reason for this requirement was largely because of the concern that some foreign income earned at the QC level could be distributed to shareholders tax-free, as unimputed dividends paid by QCs are tax exempt. At the time the LTC rules were being developed, a similar restriction was considered not to be necessary because the look-through mechanism would ensure that foreign income would be taxed at the appropriate marginal tax rate when attributed to shareholders. However, the availability of foreign tax credits to offset some or all of the New Zealand tax owing adds a further overlay.
- 4.9 New Zealand's imputation system means that preferences earned by companies, such as foreign tax credits, are not passed through to shareholders.²³ This has been a cornerstone of New Zealand tax policy since the late 1980s.²⁴ Arguably, allowing LTCs to earn significant income offshore is not consistent with this policy given that any foreign tax credits flow through to LTC shareholders. On the other hand, the counter argument is that those credits would be available if the individual shareholders invested directly.
- 4.10 LTCs also allow foreign branch losses to be applied against individual income, which creates a coherence risk. This is because the branch may be converted to a foreign company when it becomes profitable and, therefore, the foreign branch loss is never recaptured by future foreign income – instead it is available to offset domestic income. This possibility can arise with company offshore investment generally, although in the case of a LTC there may be an additional risk from being able to flow losses back to shareholders where they can be offset against the shareholder's non-business income.
- 4.11 Foreign personal services income, on the other hand, may not raise the same concerns. Also, the concerns around direct outbound investment via LTCs

²³ The theory is that this helps to incentivise investors to make foreign investments only when it is in the interests of New Zealand as a whole.

²⁴ This policy position was confirmed during the International Tax Review, and also when New Zealand's position on mutual recognition of imputation credits was reviewed.

may not be an issue in practice as only a very small proportion of LTCs (around 0.5 percent) earn foreign income and the vast bulk of those that do, earn less than \$10,000 of foreign income (see Tables 11 and 12 in Appendix 1 for more detail).

Table 4: Foreign income/losses and foreign tax credits earned by LTCs

	Number of LTCs with foreign income	Total foreign income	Total FTCs	Number of LTCs with foreign losses	Total foreign losses
2012	184	\$217.1m	\$7.2m	14	-\$0.2m
2013	239	\$29.8m	\$6.7m	21	-\$1.4m
2014*	273	\$36.2m	\$6.0m	24	-\$3.9m

*almost a complete year

Conduit investments

4.12 LTCs were designed as a domestically focussed vehicle, not as a vehicle for conduit investment. There are reputational risks with allowing conduit structures and there is some anecdotal evidence that LTCs have been used to facilitate illegal activity, though they are not the only vehicle to be so used.

4.13 In saying this, however, it is not intended to deny access to the LTC regime when shareholders have a connection to New Zealand and there are no potential reputational concerns, such as if a New Zealand family business has a shareholder that relocates to Australia for personal reasons.

4.14 Apart from reputational risks, there is the question of whether there are revenue risks associated with allowing conduit investments via a LTC. Our conclusion is that although there is some risk, it is not a major issue, for the following reasons:

- Unlike ordinary companies, LTCs do not benefit from the interest deduction provision (section DB 7 of the Income Tax Act) that provides that a company's interest expenses require no nexus with income to be deductible. This means that, on its face, a non-resident shareholder in a LTC could not deduct their share of a LTC's interest expense incurred to derive foreign income.
- Furthermore, an interest expense incurred by a LTC will be subject to the thin capitalisation rules to the extent it is owned by non-residents. The thin capitalisation rules restrict debt deductions based on a person's assets that are within the New Zealand tax base. As such, a non-resident with shares in a LTC with both foreign and New Zealand assets will not be able to deduct any more interest under the thin capitalisation rules than if the LTC had only New Zealand assets. There is scope however, for LTCs to be geared up to the 60 percent safe harbour – even if that funding is, in substance, being used to fund offshore assets.

Proposed approach

- 4.15 We consider the status quo should be retained for LTCs that are used either for onshore investment into New Zealand or offshore investment out of New Zealand. This is an “on-balance” decision taking all the above factors into account. If, in the future, concerns emerged about the efficacy of the imputation system or about the material erosion of the tax base, we would need to revisit this decision. In doing so, we would want to consider the use of similar vehicles such as limited partnerships and trusts for inbound and outbound investment.
- 4.16 We do, however, consider it appropriate to restrict the ability for LTCs to earn offshore income in the conduit context.
- 4.17 One option for this restriction would be to apply the foreign income restriction in the QC rules, where there is effectively a cap on non-dividend foreign income. However, this approach might be viewed as unduly restrictive outside of the conduit situation, such as in cases when there might be a genuine option for an individual to earn foreign income through personal services.
- 4.18 Therefore, the proposal is to restrict the extent to which a company can derive foreign income and retain LTC status if it is controlled by non-resident shareholders. In order to retain LTC status when more than 50 percent of the shareholding in a LTC is held by non-residents, the LTC’s annual foreign income²⁵ would have to be restricted to the greater of \$10,000 or 20 percent of the LTC’s gross income. This would be made an entry criterion. If this condition is breached during the income year, LTC status would be revoked for that year and any subsequent year that the condition was not met.
- 4.19 This approach should ameliorate any reputational risks related with conduit investment while providing flexibility for some degree of combined non-resident shareholding and foreign income. It should prevent a domestic family business inadvertently falling outside the rules through an owner emigrating.
- 4.20 It is important to note that addressing the LTC aspects of conduit investment does not necessarily mean that we are comfortable with conduit investments being made through other structures. Any wider review would, however, need to be undertaken as a separate project. As a general matter, we propose to monitor how different entities are used cross-border, especially in light of BEPS concerns and the broader international tax framework.

²⁵ This would be all foreign income, not just non-dividend foreign income. The current QC restriction of \$10,000 “foreign” income excludes passive dividend and interest income from overseas. However, given that the concern is particularly in relation to reputational risk, with some LTCs being used as tax sheltering/laundrying vehicles, then including all foreign income in the proposed conduit limitation rule seems appropriate.

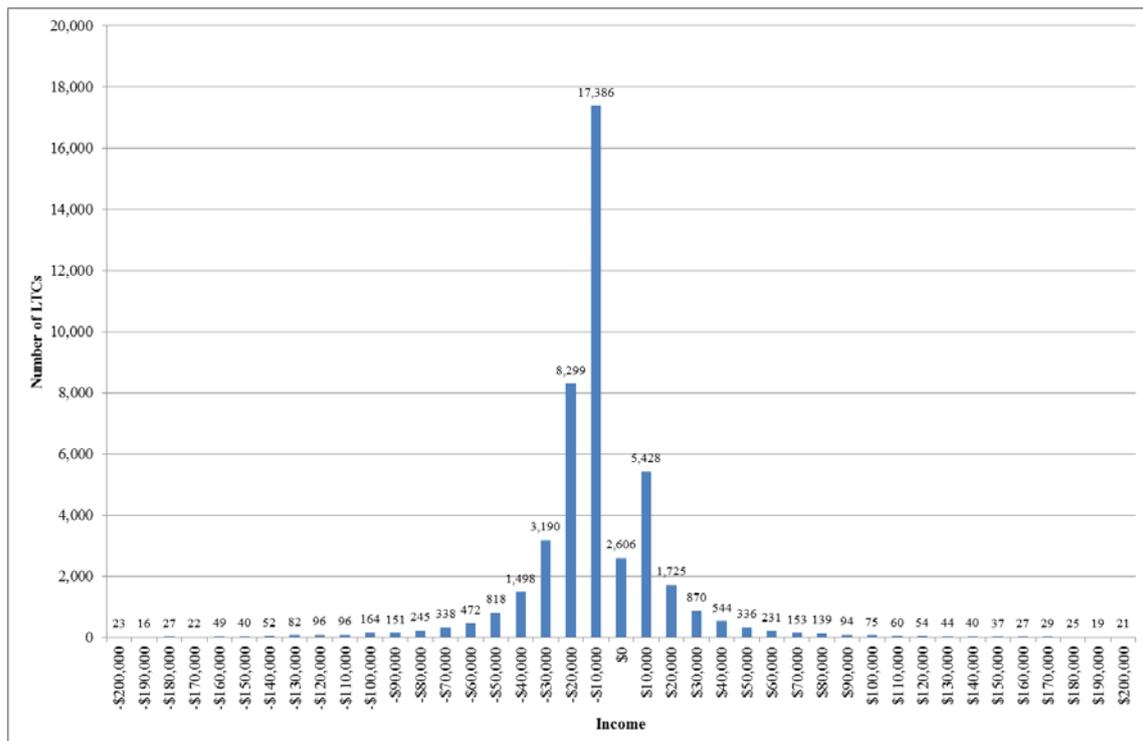
CHAPTER 5

Deduction limitation rule

Introduction

- 5.1 The income earned and the expenditure incurred by a LTC are allocated for tax purposes to the shareholders on the basis of their respective ownership. The ability of each owner to use their share of the LTC's expenditure deductions against their other income is determined by the deduction limitation rule. The rule was originally developed for limited partnerships, which generally are likely to be more sophisticated entities.
- 5.2 The deduction limitation rule is intended to ensure each owner cannot deduct tax expenses in excess of what they have invested in the business, which is referred to as their "owner's basis". Excess deductions can be a concern from both a revenue protection and economic efficiency perspective. Deductions in excess of the owner's basis are required to be carried forward for offsetting against future income subject to having adequate "owner's basis" at that point.
- 5.3 The deduction limitation rule applies to all LTCs, with all having to undertake the calculations even though in practice it only limits deductions in around one percent of cases. Consequently, the rule is one of the most heavily criticised features of the LTC rules, being criticised from a compliance cost as well as a technical perspective. The fact that the rule has such limited application is in part because, as Chart 1 illustrates, most LTCs fall into the -\$20,000 to +\$10,000 annual income range.

Chart 1: LTC income – 2013 tax year



The current rule

- 5.4 At its very basic the owner's basis is the net funds provided by the shareholder, that is, share capital plus loans to the LTC (whether by way of actual funds or a guarantee by the investor or another party) minus disbursements to the shareholder. This rule is set out in section HB 11 of the Income Tax Act, using the following formula:

investments – distributions + income – deductions – disallowed amounts

where:

investments is the sum of the equity, goods or assets introduced or services provided to the LTC, or any amounts paid by the owner on behalf of the LTC. This includes any loans, including shareholder current account credit balances, made by the owner to the LTC and their share of any LTC debt which they, or their associate, have guaranteed (or provided indemnities for);²⁶

distributions is anything paid out to the owner by the LTC, including dividends and loans, including shareholder current account debit balances. It does not include any salary or wages received by a working owner;

income is the owner's share of the LTC's income (including exempt and excluded income) and realised capital gains from the current and any preceding income years (in which the company was an LTC);

deductions is the owner's share of the LTC's deductions in the preceding income years (in which the company was an LTC) and any realised capital losses for the current or previous income years;

disallowed amount is the amount of investments made by an owner within 60 days of the last day of the LTC's income year if these are distributed or reduced within 60 days after the last day of the income year. This is to prevent the creation of an artificially high basis around the end of the year. To allow for normal operational cash-flow, if the reduction of investments within 60 days of the balance sheet date is less than \$10,000, it can be ignored.

²⁶ The rules include various definitions in relation to guarantors, owner's associates and secured amounts.

Example

In Table 5, the single owner advances \$100,000 of capital. Revenue in each year is \$60,000, of which \$30,000 is exempt income and, therefore, non-taxable. Cash costs are \$30,000 each year. The \$30,000 of revenue that is tax exempt is distributed to the owner, so no cash is retained in the company. There are no disallowed amounts. The owner's basis is calculated for the owner, as follows:

Income	30,000
Costs	30,000
Interest	0
Exempt income	30,000
Capital gains	0
Net loss	0
Distribution	30,000

Table 5: No losses created, exempt income is distributed

Y e a r	Investment	Distributions	Income	Prior year deductions	Owner's basis	Current year deductions allowed	Restricted deductions	Cumulative taxable income
1	100,000	30,000	60,000	0	130,000	30,000	0	0
2	100,000	60,000	120,000	30,000	130,000	30,000	0	0
3	100,000	90,000	180,000	60,000	130,000	30,000	0	0
4	100,000	120,000	240,000	90,000	130,000	30,000	0	0
5	100,000	150,000	300,000	120,000	130,000	30,000	0	0

However, if instead all income were to be distributed, then ultimately deductions would be limited, as follows:

Table 6: No losses created, all income is distributed

Y e a r	Investment	Distributions	Income	Prior year deductions	Owner's basis	Current year deductions allowed	Restricted deductions	Cumulative taxable income
1	100,000	60,000	60,000	0	100,000	30,000	0	0
2	100,000	120,000	120,000	30,000	70,000	30,000	0	0
3	100,000	180,000	180,000	60,000	40,000	30,000	0	0
4	100,000	240,000	240,000	90,000	10,000	10,000	20,000	20,000
5	100,000	300,000	300,000	120,000	-20,000	0	30,000	50,000

Problems with the current rule

- 5.5 There is a general perception that the current rule is overly complex for the target LTC audience, leading to material compliance costs that are unlikely to decrease over time. The calculation applies to every owner even though most will not have their deductions constrained by it because their share of costs is less than their owner's basis.²⁷ If costs exceed available funds, the shareholder can provide more equity to fund the shortfall. Nevertheless, each owner needs to make an annual calculation to determine the amount of LTC expenditure that they can deduct. Even for profitable LTCs the calculation is needed, in case the LTC eventually makes a loss, or because some of their owners may have their deductions restricted because the rule limits deductions rather than losses.
- 5.6 Moreover, it can restrict deductions in some situations where all costs would be deductible if earned directly by the owners; for example, when not all of an owner's economic interest is recognised such as when there is an unrealised capital gain.
- 5.7 Additionally, a range of technical issues have arisen in relation to how the rule and its defined terms, such as "secured amount" and "deductions", work in practice. Some of these issues have led to legislative amendments but further changes seem necessary.

Restricting the ability to apply losses against taxable income

- 5.8 Conceptually business deductions should be able to be offset against income to the extent they reflect economic costs, just as economic income (business profits and other gains that increase the value of the business) should also be taxable. Practically, there are certain restrictions on the deductions that can be claimed, just as there are restrictions on what constitutes income; for example, capital gains, which can be in effect a form of economic income, are taxed in only specific circumstances.
- 5.9 Given that LTCs are intended to be substitutes for direct ownership of assets in a closely held business, conceptually it seems appropriate to allow deductions when they would be deductible if the assets were owned directly. The exception would be where there are material differences in arrangements arising from incorporation that lead to excess deductions being claimed.
- 5.10 As an individual, the shareholder is in effect restricted to deductions that represent the economic costs that the individual has incurred. Those losses are able to be offset against an individual's income from other sources, not just income on the investment or business.
- 5.11 In contrast, in widely held situations, there is generally a separation of entity and shareholder taxation so that losses cannot be transferred from the company to shareholders.

²⁷ Around one percent of LTCs reported non-allowable deductions carried forward in 2013 – see Appendix 1.

- 5.12 Limited partnerships straddle the dichotomy between partnerships and widely held companies, with no limits on the number of persons who can be members of a limited partnership. In this way, they can be a substitute for a standard company, which means that they should face similar restrictions; hence there are deduction limitation rules for limited partnerships to ensure that deductions are not passed through when they are in excess of what is perceived to be at risk.²⁸
- 5.13 Although LTCs share many characteristics with limited partnerships, there are significant differences between the client groups and the purposes of LTCs and limited partnerships. In particular:
- the limited partnership rules were introduced, in part, as a response to a perceived problem for in-bound venture capital. LTCs are targeted at closely controlled businesses, primarily with a domestic focus;
 - LTCs are restricted to five or fewer shareholders. Limited partnerships have no such limitation;
 - LTC shareholders can, and typically will, be active in the day-to-day operation of the business. Limited partners are theoretically restricted to a passive role in the business.
- 5.14 These differences suggest we can be more relaxed about LTC deductions. Furthermore, LTC shareholders are taxable on debt remission income of the LTC (the remission rules are discussed later in Chapter 8). Thus there is less need for a deduction limitation rule as a base protection mechanism. Robust LTC entry or qualifying criteria will also reduce concerns about removing the rule as they are a useful initial filter for arrangements that could result in the generation of excess losses. In these circumstances, our conclusion is that the deduction limitation rule is needed only in specific instances.

When excess deductions arise that might justify restrictions

- 5.15 A common concern underlying the need for past restrictions on deductions has been when leveraging at the level of the company or partnership has provided significant interest deductions for the investor, without the obligation for the investor to repay the loan in the event that the project became insolvent. A variety of mechanisms were used to ensure the loans did not have to be repaid, ranging from the loan being provided on limited or non-recourse terms, to it being lent to a scheme-specific company and only secured over the assets of, and perhaps the shares in, the company. Other mechanisms included the use of put or call options over scheme assets or the use of “insurance policies”.²⁹

²⁸ Internationally, limited partnerships pose substantial risks for domestic taxation and out-bound investments, with a number of jurisdictions placing restrictions on them, as a way to counteract mass-marketed tax shelter schemes. In such schemes, tax deductions often greatly exceeded the investments made by the “investors” with profits to investors often being entirely generated by the tax system. Limiting tax deductions to economic losses makes perfect sense in such situations.

²⁹ It needs to be borne in mind, however, that the existence of a non-recourse loan, in a bona fide business arrangement, need not in itself be a problem. The same amount of interest would be deductible whether the loan was to the shareholder, or to the company, with or without a guarantee. In an arm’s length transaction, with no artificial arrangements, a financial institution would presumably only be willing to provide a loan secured against the assets of the company in situations where the probability of default was small and the assets were tangible.

- 5.16 Such ‘non-recourse’ schemes have typically involved:
- a high-risk activity with apparently optimistic or unrealistic future sales projections, and property, including intangible and intellectual property, that is difficult to value;
 - the use of non-residents, tax-exempt organisations or tax loss companies so that any income is effectively exempt from New Zealand income tax;
 - investors putting relatively small amounts of their own money into the schemes but the promoter arranging instead for the investors to have access to loan money that is used to purchase high-value assets that diminish in value, at least for tax purposes, over time.
- 5.17 Specific “money-at-risk” rules³⁰ were enacted in 2003 to address the base erosion impact posed by these schemes, but those rules are very specific and predate LTCs. These rules were targeted at mass marketed schemes that typically, but not always, used LAQCs. The overall response to these schemes, including the use of other anti-avoidance rules in the Income Tax Act, has arguably been effective as mass marketed tax driven schemes since that time have been limited.
- 5.18 There is the general anti-avoidance rule in section BG 1 that enables the Commissioner to void a tax avoidance arrangement for income tax purposes and to counteract a tax advantage that a person has obtained from or under a tax avoidance arrangement. Furthermore, the anti-avoidance rule in section GB 50 relating to the valuation of partners’ transactions is potentially of relevance, with some modification.
- 5.19 In considering changes in relation to the anti-avoidance rules, we have been mindful that any proposals need to avoid replacing one set of compliance costs with another. Ultimately, the vast majority of LTCs and owners are conducting legitimate business activities and any resultant deductions are genuine.

Arrangements involving partners

- 5.20 Section GB 50 replaces consideration paid by a partner with a market value amount when the arrangement has the purpose or effect of defeating the intent and application of the partnership tax rules (in subpart HG).
- 5.21 This requirement was designed to protect the tax base, with the concern being the transfer of assets in and out of a partnership at under- and over-value, for tax benefits. For example, a controlling partner could introduce valuable assets into a partnership to accelerate their own tax deductions, say on depreciable property.
- 5.22 The rule is not intended to affect situations where non-market transactions between partners occur legitimately. It is therefore expressed as a specific

³⁰ See sections GB 45 to GB 48 of the Income Tax Act.

anti-avoidance rule that essentially deems a transaction to have occurred at market value when the transaction is subject to an arrangement entered into to avoid tax.

- 5.23 Given that the LTC rules are based on the partnership rules, it seems logical to extend section GB 50 to include LTCs. This would at least address the valuation aspect, which is a likely feature of schemes that involve excessive deductions, irrespective of whether they are mass-marketed. Extending this rule to LTCs may, however, highlight some subtle differences. For example, a nil interest loan from a partner might be squared up through an adjustment to partners' profit shares. Such a profit adjustment cannot be readily done in the case of LTC shareholders given that allocations are according to shareholdings, although some adjustment to shareholdings may be feasible to achieve a similar outcome. Feedback is sought on this point and the general application of the section GB 50 rule.

Partnerships of LTCs

- 5.24 Partnerships of LTCs are used in certain business ventures. In effect, this is a widely held investment structure and replicates a limited partnership, but with the added advantage of each partner being able to be active in the business in some way.
- 5.25 From a policy perspective there is little cause for concern over partnerships of LTCs. However, this situation changes if the deduction limitation rule as it applies to LTCs is removed. Such a result has the potential to see limited partnerships being superseded by partnerships of LTCs as a preferred structure for widely held investments.
- 5.26 Limited partnerships have been designed as a structure to aid widely held investment where flow-through treatment is considered desirable. It therefore seems inconsistent to have an alternative structure that replicates the more favourable aspects of limited partnerships but without the restrictions that apply to them.
- 5.27 The deduction limitation rule should therefore be retained for partnerships of LTCs. Ideally this would be when there are more than five look-through counted owners in aggregate across the LTCs in the partnership. In other words, there would be more owners than would be allowed if the partnership's activities were undertaken by a single LTC. Basing the application of the test on the number of combined owners, may, however, cause practical difficulties. This is because it puts the onus on each LTC to know how many owners there are in the other LTCs in the partnership which becomes complicated if there are trusts and family groups to consider. This may mean that, for simplicity, all partnerships of LTCs would need to apply the test. Feedback on this point is invited.

Transitional arrangements

5.28 The proposed removal in most cases of the deduction limitation rule raises the issue of what to do with those deductions that are limited up to the removal of the rule and have therefore been carried forward. Such restricted deductions average around \$7m a year and are expected to have accumulated to \$35m by 2016–17, which translates to a fiscal cost of \$12m, spread over two years. Such deductions would become unrestricted from the 2017–18 income year and could, therefore, be offset against owners’ other income from that income year.

Technical changes to the deduction limitation rule

5.29 We are proposing some technical changes to the deduction limitation rule to clarify its application for those who would continue to be covered by it. The changes involve:

- a balance sheet based starting point for the calculation of “owner’s basis” for companies that enter the LTC regime;
- the inclusion of unrealised gains on real property; and
- further consideration of the treatment of guarantees, requiring among other things, that the guarantor be a person of substance and not the LTC itself.

5.30 Submissions are welcome on any other aspects of the rule that are causing concern. In the meantime, officials will continue to consider the detail of this rule with the aim of further simplification.

Balance sheet based starting point

5.31 At the moment the tax law is unclear how the term “investments” in the formula is to be calculated in respect of an existing company that elects into the LTC regime. For example, the company may have been in existence for many years. A balance sheet based approach, with adjustments (such as reversal of revaluations except in respect of real property), would provide a clean starting point.

Inclusion of unrealised capital gains into the current formula

5.32 An owner has money at risk even in relation to gains on capital assets that have not been realised. When the assets are intangible, valuing those gains with confidence can be problematic. However, in the case of real property, revaluations are already provided for in the mixed use assets rules in the Income Tax Act. Consequently, we are proposing that revaluations of real property, calculated in a similar fashion to the mixed use assets rules, be added to “owner’s basis”.

Possible alternative rule

- 5.33 We did consider whether a more fundamental change to the rule was needed, while retaining the principle of denying excessive deductions. Our conclusion was that any rule is inevitably going to be detailed given the variety of assets, liabilities and businesses that might be included in a LTC. The existing rule has been in place for several years in which case LTCs will be familiar with it and a new rule would involve another teething period. Furthermore, the proposed removal in most cases of the deduction limitation rule reduces the benefits from any fundamental rewrite of the rule. It seems preferable, therefore, to instead make some minor adjustments to the existing rule, as outlined above. However, it may be helpful to at least summarise some of our thinking on some possible alternative ways of designing a rule. This is included in Appendix 2.

CHAPTER 6

Qualifying companies

What should be done about those companies that remain as QCs?

- 6.1 An aim of the review is to make the LTC rules more workable so that more small businesses can use them. If this objective is achieved, will the LTC rules be sufficient to cover all targeted small companies, including QCs? As discussed earlier, it is not desirable to have multiple regimes covering essentially similar types of businesses but with slightly different boundaries. This is particularly the case when those regimes are optional and it is relatively easy to switch from one to the other to minimise tax liabilities.
- 6.2 Furthermore, allowing existing QCs to continue will provide them with a permanent advantage,³¹ leading to their being traded for tax purposes and potential involvement in undesirable tax behaviour.
- 6.3 While we might anticipate that the numbers of QCs will decline over time, the feedback from some stakeholders has been that the LTC regime is too limited to cover all closely held companies. For example, the requirement that there must be only one class of shares would preclude some QCs from becoming a LTC. As noted earlier, we intend to recommend allowing more than one class of shares, provided the only variation relates to voting rights.
- 6.4 Another concern is that some QCs may be deterred from transitioning into the LTC regime because under the LTC rules existing shareholders face tax consequences, such as depreciation claw-back and the taxation of any gains made on revenue account property upon exit from the LTC regime. To reduce compliance costs, the tax on the disposal of the underlying property is ignored when the tax adjustment is below certain thresholds. In contrast, under the QC rules the exiting shareholder is treated as selling their shareholding which in most cases would not have a tax consequence. Our conclusion is that although the tax consequence on disposal does create compliance costs, even with (or in some cases because of) the thresholds, it is difficult to find a robust alternative. Hence, recognising disposals seems to be a necessary feature of the LTC rules, as it is for ordinary partnerships.

Proposed approach

- 6.5 On balance, our conclusion is that the existing QCs should be retained, but a QC should lose its QC status upon the sale of the company. The loss of QC status upon sale would discourage trading in QCs where that trading is driven by their tax advantage.

³¹ A QC can provide a better outcome from the perspective of a shareholder on a 33% personal tax rate as it allows capital gains to flow through to that shareholder while taxable income is taxed at the lower company tax rate until it is distributed.

- 6.6 The sale of the company would be measured by a change in control (that is, a change in shareholding of over 50 percent in aggregate). We envisage that this would involve applying a shareholder continuity type test to measure if control had been retained by the same group of owners, using as the continuity period the period commencing from the date of enactment of the legislation up to the date of sale of an interest in the LTC.

CHAPTER 7

Transitioning into the LTC regime

Introduction

- 7.1 There are several issues in relation to the rules that apply on becoming a LTC.

Entry formula

- 7.2 We are proposing to amend the adjustment done at the time of entering into the LTC regime. The adjustment is intended to reflect the fact that retained earnings earned before becoming a LTC would have been taxable in the hands of shareholders if distributed before the company became a LTC. This in effect provides a square-up or clean slate on entry given that any distribution by the LTC will be tax-free. The adjustment amount becomes income for the LTC owners.
- 7.3 The income adjustment is based on the income that would arise if the company had been liquidated immediately before becoming a LTC, except that unrealised gains are not realised. The formula is:

$$\textit{dividends} + \textit{balances} - \textit{assessable income} - \frac{\textit{balances} - \textit{exit exemption}}{\textit{tax rate}}$$

where:

dividends is the sum of the amounts that would be dividends if immediately before becoming a LTC the property of the company, other than cash, were disposed of at market value and the company met all its liabilities at market value and it was liquidated and the net cash amount was distributed to shareholders without imputation credits or foreign dividend payment credits attached. In other words a liquidation took place;

balances is the sum of the balances in the imputation credit account and foreign dividend payment credit account immediately before becoming a LTC, plus amounts of income tax payable for an earlier income year but not paid before the relevant date, less refunds due for the earlier income year but paid after the relevant date;

assessable income is the amount of income that would arise as a result of liquidation less any deductions that the company would have as a result of liquidating. This includes depreciation gains or losses, bad debts and disposals of revenue account property;

tax rate is the company tax rate in the income year before the income year in which the company becomes a LTC;

exit exemption is the exit dividends that, if the company had previously been a LTC and is now re-entering the LTC rules, would be attributed to

any retained reserves from the previous LTC period that have not since been distributed;

- 7.4 For compliance cost reasons, the adjustment formula uses the company tax rate, currently 28%, but this means that no further tax is paid by LTC shareholders on fully imputed income, which is contrary to the liquidation concept.

Example

If on liquidation there would be a \$72 dividend with \$28 imputations credits attached, the formula produces an answer of \$0 additional income. In contrast, upon a real liquidation and for a shareholder on a tax rate of 33%, \$5 more tax would be payable.

- 7.5 The question of whether utilising the LTC rules to take advantage of any under-taxation and subsequently liquidating would be considered tax avoidance by Inland Revenue has been raised in a number of fora in recent years. As a result Inland Revenue issued a Question We Have Been Asked (QWBA) on the issue as part of a wider QWBA (No. 14/11) on tax avoidance scenarios. That QWBA indicated that avoidance will be considered to arise if there is an arrangement that involves an election to become a LTC and to subsequently liquidate.

- 7.6 However, irrespective of whether avoidance is an issue, there is still a tax rate advantage for shareholders on 30% and 33% marginal tax rates. Conversely, if the company has a predominance of shareholders who are on marginal tax rates less than 28%, then overall there is an over-taxation on becoming a LTC.

- 7.7 To achieve a more equitable outcome, we are proposing that the adjustment formula in section CB 32C(5) should be replaced with a formula that ensures the income that arises is taxed at shareholders' marginal tax rates, rather than the company rate of 28%.³² The new formula would treat the retained income and imputation credits that would arise on liquidation of the company as being distributed to the individual LTC shareholders who would include the income and imputation credits in their return of income. This approach would leave it to each individual shareholder to determine what tax rate applies to their share of the income. Allocating out the income and imputation credits would produce a fairer tax outcome but would result in additional compliance costs.

Example

Taking the earlier example, this would mean the shareholder on a tax rate of 33% would receive a dividend of \$72 with \$28 imputation credits attached, and a further \$5 would be payable.

³² A similar gap on entry into the qualifying company rules was rectified several years ago.

QCs transitioning to LTCs

- 7.8 An associated issue is how to treat transitioning QCs under the adjustment formula. Conceptually, the outcome should be, as above, as if the QC had been liquidated. Under this approach the revised formula would make it clear that consistent with the QC liquidation rules, unimputed amounts would not be taxed.
- 7.9 Previously, QCs had a two year exemption window, to encourage conversion, which included exemption from the entry formula. This is in fact not a “free” conversion as effectively imputation credits are lost, which is akin to taxing all shareholders at 28% with no subsequent square-up on taxed income. Although this benefits shareholders on 30% and 33% marginal tax rates, it disadvantages those on lesser marginal rates. Whether it results in a more tax advantageous outcome than under allocating out the income and imputation credits to all shareholders, therefore, depends on the composition of shareholders and their marginal tax rates. A QC with a preponderance of low tax-rate shareholders would always have the choice of making a distribution before electing to become a LTC, to avoid any tax disadvantage.
- 7.10 On balance, we are proposing that the standard liquidation approach should be applied. This means that not only would an entry adjustment be required, modified as suggested above, but also losses that had accumulated in the QC could not be carried over to the LTC. Allowing QC accumulated losses to be carried over would have a significant fiscal cost which would be hard to justify.
- 7.11 This would not, however, affect entitlements to losses transferred on conversion during the two year exemption window (under section DV 23). Those transferred losses have been able to be used to the extent that there has been LTC income post-conversion and this will continue to be the case.

Values at time of entry

- 7.12 A retrospective technical change should be made to clarify the values at which a LTC’s assets and liabilities are deemed to be held by the LTC owners and in the LTC accounts when an ordinary company or QC converts to a LTC. They should be based on the tax book values of the ordinary company or QC immediately before conversion.

CHAPTER 8

Debt remission

Introduction

- 8.1 Under current policy settings debt remission generates taxable income for the LTC's shareholders. This is because of the interaction of the LTC rules with the financial arrangements rules. There is concern that when a shareholder is also the creditor this outcome can be inappropriate because the shareholder will have suffered a non-deductible loss on the same loan. This chapter discusses this issue and how it can be resolved.
- 8.2 Outside of the above situation, the chapter discusses a legislative clarification to ensure that the debt remission income arises as intended when a LTC either liquidates or elects out of the LTC rules.

Related parties debt remission in asymmetric situations

- 8.3 The February 2015 consultation document *Related parties debt remission* dealt with situations where the debt, if capitalised, would lead to no change in ownership of the debtor. These aspects are not further discussed in this paper.
- 8.4 However, for "look through" entities (ordinary partnerships, limited partnerships and LTCs) there is a variation of this situation that also seems to result in an inappropriate outcome. The issue is, therefore, not necessarily confined to LTCs.
- 8.5 Consider a simple LTC situation with several shareholders, all of whom are unrelated. One of those owners lends a sum of money to the LTC. This loan would be a financial arrangement and therefore subject to the financial arrangements rules in subpart EW of the Income Tax Act. Sometime later the LTC is in financial difficulty and the loan is remitted, giving rise to debt remission income.
- 8.6 Under current tax law all shareholders would derive debt remission income in proportion to their respective shareholdings. From a policy perspective this outcome is logical for the shareholders that did not advance the loan as they have in effect made a gain.
- 8.7 However, the creditor shareholder has actually made an economic loss (of the portion that is "attributed" to the other shareholders). Yet that shareholder is taxed on their share of the remission income with no tax deduction for their actual loss.³³ This result is not the desired policy outcome.

³³ Even though a base price adjustment is required, the base price adjustment formula in effect negates the loss arising from the non-payment by including the amount remitted.

Example

George and Mario own, respectively, 60 percent and 40 percent of GEL Enterprises Limited (GEL), a look through company. In addition, George has advanced \$1 million to GEL. Some years later GEL is effectively insolvent and George chooses to remit the loan.

From a taxation perspective, Mario derives taxable debt remission income from GEL's base price adjustment (the BPA) of \$400,000 and there are no policy problems with this. George derives \$600,000 of taxable debt remission income but is denied a tax deduction for any of his \$1 million loss. Economically George has lost a net \$400,000, but he has taxable income of \$600,000.

Proposed solution

- 8.8 The proposal is to turn off the creditor shareholder's share of the debt remission income.

Example

In the above example, this would mean George would not have the \$600,000 debt remission income so that overall he would be \$400,000 out of pocket which matches the transfer to Mario, and Mario is taxed on that transfer as debt remission income.

- 8.9 Submissions on this proposal and on an appropriate application date are welcome. The change could be backdated to the inception of the LTC rules (1 April 2011) but this could result in compliance and administrative costs. We seek feedback on the extent to which shareholders of LTCs who have lent money to the LTC have found themselves in the above situation and have had to pay tax.

Loans to partnerships

- 8.10 Arguably the above approach should also apply to a creditor partner's share of debt remission income when a partner has made a loan to a partnership and the loan cannot be subsequently repaid. Comments on this aspect and examples of practical situations in which it has been a problem are welcome.

Clarifying remission income on exiting the LTC rules

- 8.11 A concern underlying the removal of LAQCs was their use in the avoidance of remission income. Under standard tax rules 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. Normally this is not an issue as any unpaid portion of expenditure is subsequently clawed back through the remitted income rules. However, shareholders of LAQCs could avoid this remission income.

- 8.12 Remission income arises in the year of remission, rather than in the year in which the deduction was originally claimed.³⁴ If remission income arose in an income year after the company had revoked its LAQC status, the directors and shareholders were not personally liable for the tax liability of the company, as that liability only applied in respect of an income year during which the company was an LAQC. As a result, shareholders could claim LAQC losses and then eliminate personal liability for the tax on the remitted income simply by revoking LAQC status before remission income was derived by the LAQC. The intention was that this outcome could not be achieved through a LTC.
- 8.13 The Income Tax Act makes it clear that remission income is intended to arise for LTC owners when they either elect to take their company out of the LTC rules or the LTC is liquidated, through their deeming to have disposed of their interests at market value. There has been some debate over whether this is the outcome in practice, although the intention is clear.
- 8.14 The issue is around the market value of any impaired third party loans at the time of disposal, with some practitioners arguing that the market value of a loan, distressed or not, is the present value of its future cash flows without considering its distressed impairment. This approach ignores the risk associated with the loan.³⁵ There are suggestions that this argument is being used to avoid remission income from distressed debt when a LTC “elects” out of the LTC regime or liquidates.

Proposed solution

- 8.15 A retrospective amendment is proposed to put an end to the above debate and to ensure that the debt remission income rules apply as intended – in other words remission income does arise for LTC owners when they either liquidate or elect to take their company out of the LTC rules.

³⁴ Remission income includes an amount of debt that has been forgiven to a debtor.

³⁵ That risk should, however, be reflected in the market price that a third party would be prepared to pay for the loan.

CHAPTER 9

Dividend simplification

Introduction

9.1 In addition to changes to the LTC rules, the review has considered whether changes should be made to the rules around distributions/dividends made by close companies that are not LTCs, and not in many cases QCs. The issues that we have been considering in this area are:

- ways to ensure that genuine capital gains made by small businesses do not become taxable merely because there is a transaction involving an associated party. There is scope to liberalise the current restrictions in this area;
- whether resident withholding tax (RWT) obligations can optionally be removed from small companies, subject to the company or its directors providing guarantees. This would be designed to reduce an area of compliance costs;
- likewise, whether the requirement to deduct RWT from fully imputed dividends between companies could be optionally removed;
- ways of streamlining RWT obligations when cash and non-cash dividends are paid concurrently. Again this would reduce compliance costs and produce more sensible outcomes;
- whether small businesses could be given the option of treating shareholder salaries as subject to a combination of PAYE and provisional tax. This would be aimed at providing businesses with greater flexibility.

Tainted capital gains when capital asset sold to non-corporate associated person

9.2 This issue concerns the distribution of capital gains and the associated party rules, particularly where there is a family business reorganisation. The basic issue can be illustrated by the following example:

Example

Mark is the sole shareholder of C Ltd, which purchases two farms for \$100,000 each. Mark has two sons, Henry and James, who each live on one of the farms. When Mark retires, his shares in C Ltd are transferred to his sons equally.

Soon after, Henry's farm is transferred from C Ltd to himself. The transaction is concluded by Henry selling his shares to James for \$150,000 (actual market value) and using the proceeds to buy the farm on which he resides also at the market value of \$150,000; there is, prima facie, a \$50,000 capital gain for C Ltd.

When C Ltd eventually liquidates, a \$50,000 taxable dividend arises on the distribution of the gain from the sale of Henry's farm, because it was transferred to an associated person.

The \$50,000 gain does not qualify as a capital gain of the type that can be distributed tax-free under the company liquidation rules, because of the sale from C Ltd to Henry was to an associated person. Consequently, the gain is referred to as being 'tainted'.

9.3 The policy rationale for treating a gain from the sale of an asset to an associated person as tainted is to prevent an asset being transferred around a group of companies for the purposes of creating additional amounts of capital reserves that may be distributed tax-free. The restriction dates back to the 1980s.

9.4 The original rationale only holds if the sale is to a company, but in practice the restriction also encompasses genuine transactions where the sale is not to a company. In other words, the restriction seems to extend beyond its intended ambit. Companies can be inadvertently caught by the rule, resulting in their being unable to be subsequently liquidated without a tax impost.

Proposed solution

9.5 To reduce the ambit of the restriction, we propose that the tainting rules should not apply when the associated person purchaser is not a corporate. This amendment would be restricted to companies meeting the current definition of "close company", that is, a company that has five or fewer natural persons the total of whose voting interests in the company is more than 50 percent (treating all natural persons associated at the time as one natural person).

Potential related issue

9.6 It is not uncommon for a family-type company to go through a development phase and then either its shares or its assets are sold to a different organisation. When the former owners of the company have no interests in the new organisation this yields a non-tainted result.

9.7 However, when the acquiring organisation is a company in which the former owners end up owning shares as a result of the transaction, they might end up being associated persons. This would result in a tainted capital gain. We are hesitant to make changes in this area given the scope for inflating gains, the rationale behind the limitation. However, we will continue to analyse the issue and invite submissions on it.

Tainted capital gains when capital asset owned by more than one company in a group of companies

- 9.8 A similar concern about a possible over-valuation arises when a capital asset moves around a group of companies. This can be illustrated in the following example:

Example

A Ltd and B Ltd are 100 percent commonly owned group companies. A Ltd purchases a property for \$100. Several years later A Ltd sells the property to B Ltd for \$1,000. A Ltd records a gain on sale of \$900.

Several years later, Person Z, who is not associated with A Ltd and B Ltd, purchases the property from B Ltd for \$1,200 and A Ltd and B Ltd are then liquidated.

Under current law, a taxable dividend of \$900 arises from A Ltd on liquidation because the property was sold to an associated person (B Ltd) and therefore the gain is not recognised as a capital profit. B Ltd can distribute \$200 tax-free to its shareholders (being \$1,200 less \$1,000).

Had the property not been transferred between A Ltd and B Ltd, but instead brought by a non-associated person/company for \$1,200 shortly before A Ltd's liquidation, the full \$1,100 gain (\$1,200-\$100) could have been distributed tax-free.

Proposed solution

- 9.9 When there is a group of companies and one of the companies sells an asset to an unrelated third party, the extent to which the capital profit on the sale would qualify for a tax-free distribution on liquidation would be determined with reference to the original cost of the asset, ignoring any tainted gains arising from previous intra-group sales of the asset.

- 9.10 There would be no limit on the type of companies to which this could apply.

RWT compliance issues

- 9.11 There are several issues with the application of RWT to dividend and interest payments made by closely held companies to their shareholders.

Dividends

- 9.12 Subject to the attachment of imputation credits, the RWT rate on dividends is a flat 33%. The lowering of the company tax rate to 28% means that even fully imputed dividends must have RWT deducted. This creates a compliance burden on companies, and in particular SME companies that pay fully imputed dividends. It also creates over-taxation for corporate shareholders who suffer RWT deductions from fully imputed dividends and for individual shareholders who are not on the top personal tax rate. Any excess RWT then needs to be claimed as a refund when the tax return for the relevant income year is filed, which not only means refund delays but also a

compliance burden on those individuals who may not otherwise have had to file a return.

9.13 Two specific compliance issues that have been raised with us in relation to the timing of dividend payments and associated RWT deductions are:

- RWT is due the month after the dividend is “paid”, but for many companies the dividend’s quantum is sometimes not determined until after this time.
- It is common practice to retrospectively clear a shareholder’s overdrawn account by a year-end credit for dividends. This credit is deemed to arise on the later of the first day of the relevant income year or the date the “loan” (by way of overdrawn account) was made; so that no tax or FBT arises on the “loan”. However this treatment does not apply if tax is deducted from the dividend. Because the company tax rate change means that RWT is now required to be deducted from all dividends, whether fully imputed or not, the ability to backdate a dividend to clear an overdrawn account no longer exists.

Interest

9.14 On interest, the RWT varies according to the shareholder’s marginal tax rate. It is common for companies to pay interest to associated persons. Again, if RWT on this interest did not need to be accounted for there would seemingly be compliance savings for the payer.

9.15 These matters were considered in the review.

Possible solution

9.16 One possible solution would be to allow a close company to elect to remove RWT on its dividends, and possibly interest payments, to shareholders (and persons associated with shareholders), subject to the directors of the company providing a guarantee that they will pay the tax on any untaxed part of the imputed dividend or interest payment should the shareholders fail to do so. A directors’ guarantee would be considered a necessary backstop even though the shareholders and the company would be likely to be closely linked.

9.17 There would be both compliance cost savings for the paying company and very likely administration cost savings with this approach, especially when returns are manually prepared. However, some of the compliance costs would be switched from the payer to the recipient. Some recipients of the dividends or interest may face increased compliance costs through having to file a tax return when they would not otherwise have to do so and/or through having to pay provisional tax when they are currently under the provisional tax threshold.

9.18 The optional removal of RWT would also give rise to fiscal costs from the deferral of tax. Some of this deferral is transitional, involving the deferral of tax that would have been paid in the first year of the change as RWT to its being paid as a combination of terminal tax and higher provisional tax

payments in the following year. This one-off retiming of payments accounts for much of the deferral. However, there is also a permanent deferral for those who would have had RWT deducted in the current year but who instead for all future years pay the tax by way of terminal tax in the following year. Added to this is a higher potential for non-compliance in the absence of a withholding tax. Our best estimates of these various elements in combination is as follows:

Table 7: Fiscal costs of possible RWT solutions

Optional removal of:	Year 1 (\$m)	Year 2 (\$m)	Year 3 (\$m)	Year 4 (\$m)	Year 5 (\$m)
RWT on dividends	-145	+102	-4	-4	-4
RWT on interest	-161	+117	-2	-2	-2

9.19 It is not clear that the possible compliance savings warrant incurring such fiscal costs. In these circumstances, these matters would best be considered in the wider context of the work being undertaken to streamline business tax processes, as discussed in the Government green paper *Making Tax Simpler* (March 2015). Part of this work involves looking at ways to streamline the methods for paying tax more generally.

9.20 In deriving these estimates, it is assumed that the dividend RWT is received in the fiscal year before it is claimed by the receiving shareholders. However, it has been suggested to us that the recognition of some dividend RWT payments may in fact arise later. We are interested in feedback on what is the current practice in terms of paying the RWT, including in relation to clearing a shareholder's overdrawn current account.

Associated issue – RWT on dividends between companies

9.21 The lowering of the company tax rate to 28% has also meant that even fully imputed dividends between companies are subject to RWT unless they are part of the same wholly owned group or the recipient holds a certificate of exemption. Giving the paying company the option of not withholding RWT in such cases would lower compliance and administration costs in relation to those companies who are able to readily identify their corporate shareholders. This should be of benefit to a wide range of companies. It is expected to have only a transitional fiscal cost (\$9m, in the first year of application).

Proposed solution

9.22 When a fully imputed dividend is paid to another company, applying RWT to that dividend would be optional.

Cash and non-cash (taxable bonus) dividends

- 9.23 The contemporaneous payment of a cash and non-cash dividend (such as a taxable bonus issue) is regarded as being two separate dividends. Consequentially, the RWT can be higher than it should.
- 9.24 Sections RE 13 and RE 14 of the Income Tax Act, respectively, deal with the amount of RWT necessary for cash and non-cash (other than taxable bonus issues) dividends, as follows:

Cash dividends

- 9.25 The section RE 13 formula is:

$$RWT = (tax\ rate \times (dividend\ paid + tax\ paid\ or\ credit\ attached)) - tax\ paid\ or\ credit\ attached$$

where:

tax rate is the basic tax rate applying to dividends, that is 33%;

dividend paid is the net amount of the dividend before the addition of credits;

tax paid or credit attached is imputation credits and FDP credits (or foreign withholding tax paid or payable on the dividend where the company is not resident in New Zealand).

Example

A cash dividend of \$72 with imputation credits of \$28, and no FDP credits:

$$RWT = (0.33 \times (\$72 + \$28)) - \$28 = \$5$$

Non-cash dividends other than bonus issues in lieu

- 9.26 The section RE 14 formula is:

$$RWT = (tax\ rate \times dividend\ paid / (1 - tax\ rate)) - tax\ paid\ or\ dividend\ attached$$

- 9.27 The key point is that “dividend paid / (1 – tax rate)” is a gross-up calculation to allow the gross dividend including both imputation credits and RWT to be calculated.

Example

A non-cash dividend of \$72 with imputation credits of \$28, and no FDP credits:

$$\text{RWT} = (0.33 \times \$72 / (1 - .33)) - \$28 = \$7.46$$

The gross dividend in this case is, therefore, $\$72 + \$28 + \$7.46 = \107.46 ,³⁶ in other words the dividend has been grossed-up for the RWT amount. This is because RWT cannot be deducted out of a non-cash amount.

- 9.28 Now take the situation where both a cash dividend and a non-cash dividend are paid out contemporaneously with the objective of using the cash dividend to pay the RWT on both the cash dividend and the non-cash dividend. In such a situation gross-up should be unnecessary.

Example

A cash dividend of \$5 and non-cash dividend of \$67, with imputation credits over both dividends of \$28.

Intuitively, this is equivalent to a gross dividend of \$100 with imputation credits of \$28, on which RWT would be \$5, with no gross-up necessary. However, under the current legislation, a gross-up is required on the non-cash dividend.

Proposal

- 9.29 The proposal is to provide the option of combining cash and non-cash dividend payments as a single cash payment, where the cash dividend alone is sufficient to cover the total RWT.

- 9.30 A legislative amendment would be required to enable the two dividends to be treated as a single dividend. It would only apply when the cash dividend was sufficient to cover the RWT for both dividends (so RWT would be paid by deduction, rather than gross-up). In such cases, the term “dividends paid” in section RE 13 would include both the cash and non-cash dividends, that is, the formula for determining the amount of RWT would be:

$$\text{tax rate} \times (\text{cash dividend} + \text{non-cash dividend} + \text{tax paid or credit attached}) - \text{tax paid or credit attached}$$

- 9.31 There would be no limit on the type of companies to which this could apply, although it is likely to be particularly relevant for closely-held companies that are not LTCs.

³⁶ Tax at 33% on this gross amount of \$107.46 equals the sum of the tax credits (\$28) and RWT (\$7.46), that is \$35.46.

Shareholder salaries

9.32 Shareholder salaries are theoretically either totally subject to PAYE or not subject to PAYE at all. There have been suggestions that allowing a combination of PAYE and provisional tax would be helpful, in particular when the base amount is subject to PAYE.

9.33 Under section RD 3, a shareholder-employee in a “close company” who either:

- does not derive as an employee salary or wages of a regular amount for regular periods of one month or less throughout the income year or that total 66 percent or more of their annual gross income in the corresponding tax year as an employee, or
- is not paid an amount as income that may later be allocated to them as an employee for the income year,

can choose to treat all amounts paid to them in the income year in their capacity as an employee as not subject to PAYE. This “no PAYE” option is designed to deal with situations where the annual “salary” is not known until after year-end – that is, it is dependent on the year-end results. The employee then includes the income in their tax return and there may be provisional tax implications.

9.34 The provision predates imputation and, therefore, focuses on preventing double taxation of “family” type companies by allowing pre-tax profits to be designated as shareholder’s salary in qualifying circumstances. This payment mechanism is still widely accepted and used today.

Proposal

9.35 A combination of PAYE on some payments and no PAYE on others should be an option available to shareholder-employees of close companies. This would be available when a base salary is provided to the employee (which would be subject to PAYE) but the overall salary payments would not be known until after year-end because it is dependent on the year-end results. Such an approach, if adopted, should be applied consistently from year to year so that a shareholder-employee should not be allowed to swap in and out of the provisional tax regime.

9.36 This change would also impact on QCs as well as other closely controlled companies given the current definition of “close company” in the Income Tax Act.

APPENDIX 1

Statistics

Profile of QCs, LAQCs and LTCs

Table 8 shows that there were a large number of LAQCs and QCs before the 2010 Budget. The vast majority (95 percent) were LAQCs, suggesting that access to losses at the personal level was a major attraction in the formation of QCs. Most LAQCs with activity (about 80 percent) attributed losses.

However, around 20 percent of LAQCs were tax-paying. These could have been companies in cyclical industries, or they could have represented companies that had start-up losses after they were established, but had now matured and become profitable; or profitable firms that might eventually have losses to attribute.

Table 8: Number of QCs and LAQCs in 2009 tax year

QCs	Number
Profit making	4,257
Loss making	1,902
Nil returns	1,457
Total	7,616
LAQCs	
Profit making	24,377
Loss making	84,624
Nil returns	27,041
Total	136,042
Total (QCs + LAQCs)	143,658
LAQC as % of total	94.7%

Since the 2010 reforms, the composition has changed significantly. Companies that were LAQCs have become either QCs or LTCs. However, Table 9 indicates that there are fewer entities overall in these categories, suggesting that some have chosen to wind up or carry out business under another form.

Many of these new LTCs are involved in real property. This tallies with earlier data on the distribution of QC/LAQC losses by industry, as shown in Table 10.

Table 9: Total numbers of LAQCs, QCs and LTCs since 2010 reforms

	Tax year		
	2011	2012	2013
LAQCs	133,617	1,310	0
QCs	6,282	80,346	68,844
LTCs	0	43,826	46,182

Before Budget 2010, half the companies passing through losses were in the property industry. But loss pass-throughs were widely distributed across the other industries. For most industries, around half the firms were passing through losses.

Table 10: Distribution of loss pass-throughs by industry for 2011

	Percent of total losses passed through	Number pass through	Percent of firms in industry passing losses through	Average loss
	%	Number	%	\$
Agriculture	16	5,289	49	\$61,000
Mining	0	43	43	\$70,000
Manufacturing	3	1,668	46	\$38,000
Utility & waste	0	62	45	\$16,000
Construction	3	2,277	36	\$29,000
Wholesale trade	2	1,136	47	\$28,000
Retail trade	5	3,384	50	\$30,000
Food/accommodation	5	2,497	65	\$39,000
Transport	2	1,045	48	\$33,000
Information/telecom	0	470	58	\$19,000
Finance/insurance	3	1,948	62	\$27,000
Property	47	41,862	83	\$22,000
Professional service	3	3,237	42	\$19,000
Admin service	1	506	52	\$22,000
Public admin	0	27	38	\$0
Education	0	281	50	\$21,000
Healthcare/social	1	568	34	\$46,000
Arts & recreation	1	598	62	\$32,000
Other services	1	1,060	49	\$20,000
Not elsewhere included	1	1,263	75	\$21,000
Unknown industry	4	3,880	70	\$21,000
Total	100	73,101	65	\$27,000

Distributions of LTC and QC income and losses

Charts 2 and 3 show the distribution of reported income and losses for LTCs and QCs in 2013. 80 percent of LTCs fell into the loss/income range -\$30,000 to +\$10,000 while 80 percent of QCs fell within the -\$20,000 to +\$20,000 range. Given that LTCs allow loss flow-through, it is not surprising that a higher proportion of LTCs were reporting losses, although the difference is not great.

Chart 2: Distribution of combined LTC and QC income – 2013 tax year

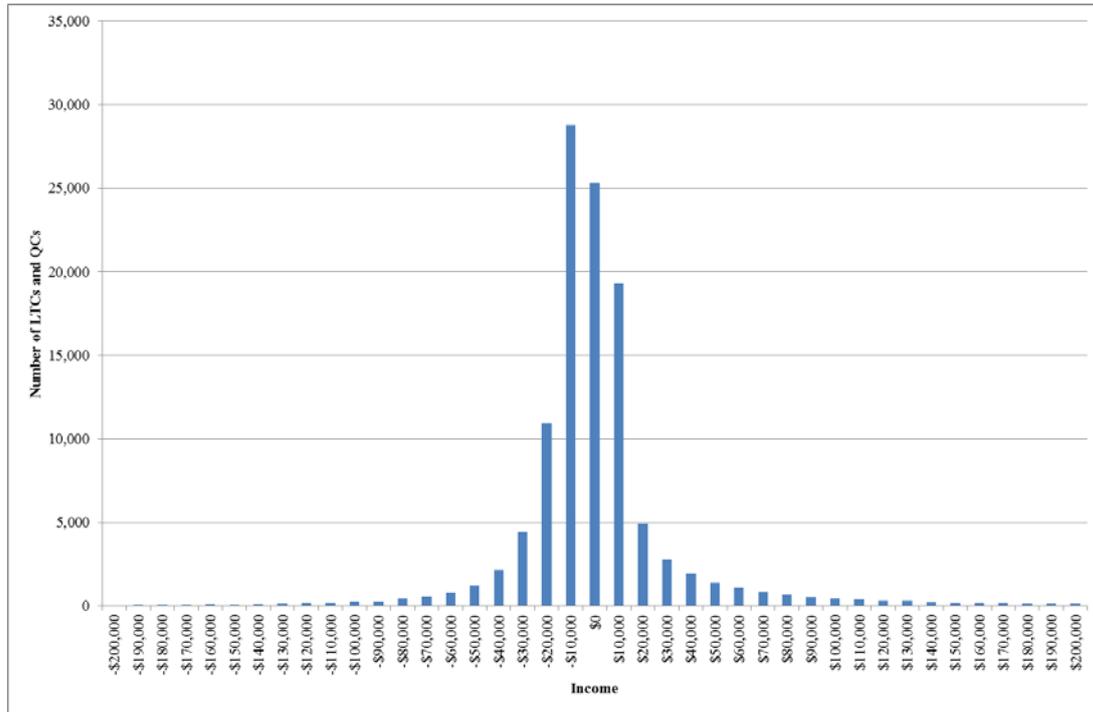
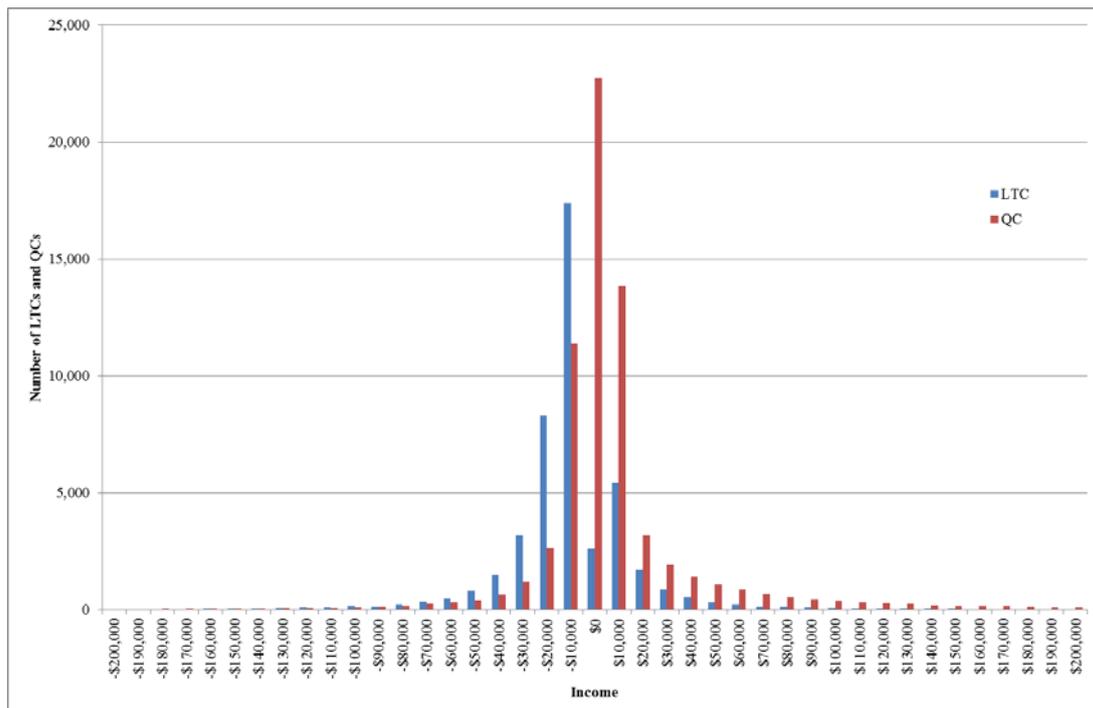


Chart 3: Distribution of LTC and QC income – 2013 tax year



Deduction limitation rule

In terms of non-allowable deductions, the number of LTCs reporting non-allowable deductions carried forward as at the end of the 2013 tax year was 446 (around one percent of total LTCs). The number of look-through owners affected was 695. The average value of non-allowable deductions carried forward per owner was \$16,547.

Overseas income

Table 11: LTCs with overseas income, foreign tax credits and losses

	Number of LTCs with foreign income	Total foreign income	Total FTCs	Number of LTCs with foreign losses	Total foreign losses
2012	184	\$217.1m	\$7.2m	14	-\$0.2m
2013	239	\$29.8m	\$6.7m	21	-\$1.4m
2014*	273	\$36.2m	\$6.0m	24	-\$3.9m

*almost a complete year

Table 12: Distribution of overseas income and losses

Overseas income			Overseas losses		
\$000s	Number of LTCs		\$000s	Number of LTCs	
	2012	2013		2012	2013
0 to 10	141	162	0 to -10	10	7
10 to 20	8	16	-10 to -20		7
20 to 30	6	6	-20 to -30	1	
30 to 40	4	8	-30 to -40		1
40 to 50	1	6	-40 to -50	1	
50 to 60	3	3	-50 to -60		1
60 to 70	3	1	-60 to -70		1
70 to 80		2	-70 to -80	2	1
80 to 90	1	3	-80 to -90		
90 to 100	1	2	-90 to -100		3
100+	16	30	-100+		
Total	184	239	Total	14	21

Distribution of LTC owners

Table 13: Number of owners reported in 2013 LTC returns

Number of owners	Number of LTCs
1	14,002
2	28,556
3	2,149
4	992
5	197
6	89
7	20
8	13
9	5
10	1
11	1

APPENDIX 2

Alternative deduction limitation rules

A number of different ways to structure and apply a deduction limitation rule were considered during the course of the review. These were:

“Money at risk” versus “good money”

An alternative to the current owner’s money at risk approach would be to focus on the “good” money in the business. Under the “good money” approach deductions could be higher as long as they are genuine. For example, the owners would be allowed more deductions to the extent that the LTC has loans from third parties that are not subject to any security or guarantee provided by its owners. A prime example of such third party financing would be negative pledge financing from a bank – this is genuine business financing but is not money that the owners have at risk. Deductions would be allowed for a standard company but could not be passed through to shareholders to offset against their other income. In most cases, however, lenders would require security on any lending in which case the “at risk” and “good money” approaches should be broadly comparable.

Per LTC or per owner

The current rule calculates each owner’s “money at risk” and limits their deductions to that amount. The rule could alternatively be calculated on a per LTC basis, which may be simpler. Under the per LTC approach any restrictions on deductions would automatically flow through to owners according to their shareholding, irrespective of the amount that each owner has at risk.

A possible drawback to this approach is that it could produce a different allocation than under the current rule when owners have provided differing levels of lending or guarantees. This might lead to negotiations among owners to maintain relativities. The rule would ignore this aspect.

A further issue is where there is a change of shareholding in the LTC – the new owner would have a different “owner’s basis” and reconciling this may not be easy.

Starting with shareholders’ funds

Using shareholders’ funds at year-end, as taken from the annual accounts, as the starting point rather than adding investments and other inflows, less outflows, since inception of the LTC could be simpler in the longer term. Net shareholders’ funds automatically takes realised capital gains into account but there would need to be adjustments to deduct:

- any revaluations of assets other than real property;
- overdrawn shareholders’ current accounts and any loans to associates of shareholders;
- any unrecorded impairment where assets are significantly overvalued; and
- intangible assets owned by the LTC.

To this would need to be added:

- loans from shareholders or associated non-corporate persons; and
- loans to the LTC that are not already counted that are unconditionally guaranteed by the shareholders or persons of substance associated with the shareholders.