

# Regulatory Impact Statement

## Shareholder Continuity: Directors' Knowledge Provision

### Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to resolve uncertainty regarding the application of section YC 15 of the Income Tax Act 2007 (the directors' knowledge provision). The provision was introduced to prevent the structuring of share transfers to take advantage of the tracing concessions. Under the section, shareholder continuity is deemed not to be satisfied when the directors of a company know or could reasonably be expected to know that the requirements of any continuity provision would not have been satisfied. However, there is a lack of certainty as to how the directors' knowledge provision should be interpreted and applied to "off-market" transactions, i.e. share transactions occurring outside of a recognised stock exchange.

Other than set out in this Disclosure Statement and the broader Regulatory Impact Statement (RIS), no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties have been identified.

In preparing this statement, we have consulted with the Treasury, which agrees with our analysis.

The amendment does not impose additional costs, impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles. The preferred option will in fact reduce compliance costs on companies.



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## STATUS QUO AND PROBLEM DEFINITION

1. The shareholder continuity rules prevent a company from carrying forward tax losses and imputation credits if the economic ownership of the company changes by more than a certain percentage over a certain period of time. In order for a company to carry forward tax losses, a minimum of 49 percent shareholder continuity needs to be maintained. For imputation credits, a minimum of 66 percent shareholder continuity is required.
2. What is now section YC 15 (the directors' knowledge provision) of the Income Tax Act 2007 was introduced into the shareholder continuity rules order to prevent the structuring of share transfers to take advantage of the tracing concessions also available under the rules. These tracing concessions are intended to reduce the compliance costs of tracing through to the ultimate natural person shareholders in a listed company, which are relatively high compared to the benefits to be gained from such tracing.
3. Under the section, shareholder continuity is deemed not to be satisfied when the directors of a company know or could reasonably be expected to know that the requirements of any continuity provision would not have been satisfied (but for the tracing concessions). However, there is a lack of certainty as to how the directors' knowledge provision should be interpreted and applied to "off-market" transactions, i.e. share transactions occurring outside of a recognised stock exchange.
4. Currently, the directors' knowledge provision has three tests which must all be satisfied in order for it to breach continuity. The tests are as follows:
  - (i) the company would have breached continuity but for the application of one or both of the tracing concessions available under the continuity rules; and
  - (ii) the breach was not due only to trading on a recognised stock exchange between shareholders with holdings of less than 10 percent ("on-market trading"); and
  - (iii) the directors of the company have actual or constructive knowledge of the breach.
5. The rationale for excluding minor on-market trading is that for listed companies, it may not be possible for the directors to know whether or not the requirements of the continuity provision have been met. This is because it is difficult to monitor changes in shareholdings on a continuous basis given numerous shareholders, the length of the continuity period, large volumes of shares traded on a regular basis and the fact that corporate shareholders may not be transparent.
6. Most listed companies regularly undertake minor off-market transactions, for example, employee share schemes, dividend reinvestment plans and off-market repurchases of shares. In addition, minor off-market transactions may occur between shareholders in such companies, such as small private sales. The frequency with which these transactions occur means that the tracing concessions may have very limited application for listed companies. This is because, under the current wording of the directors' knowledge provision, if a company undertakes any off-market transactions, however minor, continuity may potentially be deemed to be breached (if the other tests are also satisfied). In such cases, listed companies may then be required to undertake full tracing, which would be unduly

onerous, for similar reasons as those that apply to minor on-market transactions (outlined in paragraph 5).

7. Retaining the status quo would mean that considerable uncertainty would remain about the application of the legislation to off-market transactions. This lack of certainty creates considerable compliance costs, particularly for listed companies, which may be required to undertake a full tracing of their shareholders.

8. This RIS considers how section YC 15 should be amended to remove ambiguity about its application and make it easier for companies to comply with it.

## **OBJECTIVES**

9. The intention is to clarify the scope and application of section YC 15, particularly with respect to off-market transactions. This should provide certainty and reduce compliance costs, especially for listed companies.

10. A further consideration is that the scope of the directors' knowledge provision should be restricted to target only those transactions that are mischievous, in line with the policy intent behind the rule – that it is an anti-avoidance rule to prevent the structuring of share transfers to take advantage of the tracing concessions.

## **REGULATORY IMPACT ANALYSIS**

11. The options that we have identified are to retain the status quo and let companies and Inland Revenue deal with continued uncertainty, or to change the tax legislation to address the uncertainty.

12. Two different options for amending the legislation were considered. These were:

- (i) *Specifying particular types of off-market transactions which should be excluded from the scope of the directors' knowledge provision*

13. This approach would provide certainty as to the types of off-market transactions which are considered to be potentially mischievous and those which are not, which would consequently reduce compliance costs for companies, as they could disregard the excluded off-market transactions when calculating shareholder continuity.

14. However, it would be difficult to define with precision the different types of off-market transactions which should be excluded. In addition, it is likely that the list of excluded transactions would have to be amended as new types of off-market transactions come to light.

15. This option has no fiscal, social, environmental or cultural costs.

- (ii) *(Preferred option) Introducing a de minimis for off-market transactions between shareholders in a company and between a company and its shareholders*

16. This approach provides a "bright-line" test for off-market transactions, which will assist in providing certainty. However, there may be a risk that the threshold is either too generous or too restrictive. The chosen threshold of 5 percent for off-market transactions aligns with the threshold that exists under securities law for triggering disclosure by shareholders of their

interests in a New Zealand-listed company to that company. Aligning to some extent with the approach taken under securities legislation should make compliance easier.

17. This approach will reduce compliance costs for listed companies applying the provision, as it provides certainty about the treatment of off-market transactions. Companies will only have to take into account those off-market transactions their directors have knowledge of or those it is reasonable for their directors to have knowledge of, which will also reduce compliance costs. Those transactions that are unlikely to be mischievous will not have to be counted for the purposes of the directors' knowledge provision.

18. This approach is consistent with the policy rationale behind the provision, which is to target share transactions intended to take advantage of the tracing concessions. Therefore, this option aligns with what we understand is current practice and balances avoidance concerns with reducing compliance costs.

19. No fiscal, social, environmental or cultural costs are expected to arise under this option.

20. If option (ii) is adopted, the following transactions should be disregarded when applying the directors' knowledge provision:

- (i) on-market trading between less than 10 percent shareholders in the income year;
- (ii) off-market transactions between a company and its shareholders which in aggregate are less than 5 percent of the shareholding in a company in the income year; and
- (iii) off-market transactions between less than 5 percent shareholders in a company in the income year.

## **CONSULTATION**

21. Inland Revenue has consulted with a range of interested parties, including the Corporate Taxpayers Group, the New Zealand Institute of Chartered Accountants, the New Zealand Law Society and the major accounting firms.

22. Submitters supported clarifying the law and agreed with the general approach of excluding minor off-market transactions from the scope of the directors' knowledge provision. One submitter (PricewaterhouseCoopers) preferred option (i) over option (ii) and suggested combining that option with a carve-out for listed companies.

23. Inland Revenue has also consulted with the Treasury.

## **CONCLUSIONS AND RECOMMENDATIONS**

24. The recommended option is (ii); to amend the directors' knowledge provision under the shareholder continuity tax rules to exclude both minor on-market and off-market transactions. This provides certainty for companies and Inland Revenue and minimises compliance costs. This change would have retrospective application, in order to enhance certainty.

## **IMPLEMENTATION**

25. The necessary legislative changes will be included in the November 2010 tax bill.

26. The amendment would apply retrospectively for income years beginning on or after 1 April 2005. The rationale for retrospective application is that the proposed approach reflects the way that we understand the law is currently being applied by the majority of taxpayers. Furthermore, making the changes retrospective should remove uncertainty about the application of the current law to past situations officials are aware of. A possible risk with making the amendment retrospective is that it may disadvantage taxpayers who have taken a conservative position under the current tax law. However, this is unlikely to be a concern in practice, as the proposed amendment provides more favourable treatment for taxpayers than the existing law.

#### **MONITORING, EVALUATION AND REVIEW**

27. Inland Revenue's Large Enterprises will monitor the outcomes pursuant to the Generic Tax Policy Process to confirm that they match the policy objective.

