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CLOSE COMPANIES AND PARTNERSHIPS

CONTENTS **Paragraph Nos.**

ATTACHED PDFs:

- Comparison of qualifying company, partnership/limited partnership and look-through company tax regimes [including changes in the *Taxation (Tax Administration and Remedial Matters) Act 2011* and the *Taxation (Annual Rates, Returns Filing and Remedial Matters) Act 2012*]
- Interest deductibility by LTCs: IRD answers to questions on LTC interest deductibility discussed in the context of IRD rulings on interest deductibility by partners

1.TAX RATES

1. The company tax rate is 0.28 for income years from 2011-12 onwards.

2. For the 2008-09 to 2010-11 income years, the company tax rate was 0.30. [Prior to that, for the 2007-08 income years and earlier it was 0.33.]

3. Individual tax rates for partners and LTC owners who are natural persons, from the 2011-12 income year onwards are:

$0 - $14,000	0.105
$14,001 - $48,000	0.175
$48,001 - $70,000	0.300
$70,001 upwards	0.330

4. Individual tax rates for the 2010-11 income year are:

$0 - $14,000	0.1150
$14,001 - $48,000	0.1925
$48,001 - $70,000	0.3150
$70,001 upwards	0.3550

2. NEW TAX RULES THAT APPLY FROM 1 APRIL 2011

2.1Entry into QC regime closed and LAQC rules repealed

5. Entry into the Qualifying Company (QC) regime is closed. Standard, or late, balance date companies (balance dates from 31 March to 30 September) must have already been in the QC regime at the end of their 2010-11 income year. Early balance date companies (balance dates from 1 October to 30 March) must have been in the QC regime at the end of their 2011-12 income year.

6. Elections into the QC regime had to have been made before the *beginning* of the income years mentioned in the previous paragraph. However a company filing a tax return for the first time, (for the 2010-11 income year, or if it is an early balance date company for the 2011-12 income year), has until it is due to file that return, to elect into the QC regime from that first year.

7. An amendment contained in the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012* ["*Annual Rates Tax Act*"] provides that following an amalgamation between a non-QC company and a QC (i.e. an amalgamation that is not a "resident's restricted amalgamation), the resulting amalgamated company cannot use the QC rules. The amendment applies to amalgamations on or after 2 November 2012, the date of assent. (See page 27 of the attached PDF on *QC/Partnership/LTC Comparison*)

8. The Loss Attributing Qualifying Company (LAQC) regime has been repealed, with effect from an LAQC's first income year beginning on or after 1 April 2011. For standard and late balance date LAQCs, the 2010-11 income year will be their last year as an LAQC. Early balance date LAQCs remain LAQCs until the end of their 2011-12 income year.

9. LAQCs that continue to meet the requirements of the QC regime will become ordinary QCs, at the beginning of the 2011-12 income year (or 2012-13 for early balance date LAQCs).

2.2 Loss attribution alternatives

10. Shareholders in LAQCs, who wish to retain loss attribution, could make use of the transition concessions to transition into any of three alternative tax regimes that will continue to allow loss attribution. They are:
    - The new look-through company (LTC) tax regime.
    - The partnership or limited partnership tax regime.
    - A sole tradership.

11. For the concessions to apply, the transition to the new tax regime must have taken place in the 1st or 2nd income year beginning on or after 1 April 2011. The transition election must have been filed within 6 months of the beginning of the chosen transition year. There is no tax cost if these, and certain other transition requirements were met. (Note: An extension for a further 6 months to 31 March 2012 applied to QCs that wish to transition in 2012 but were not able to file the election within the first 6 months of the year as a result of the Canterbury earthquake – refer to page 12 of the attached PDF on *QC/Partnership/LTC Comparison*.)

12. The transition into the new LTC regime would be easiest from a (non-tax) legal and regulatory perspective. Some changes would have to be made to the QC's Constitution to ensure the LTC shareholding requirements are met. (See pages 5, 7 & 8 of the attached PDF)

2.3 Flat-owning companies

13. A QC that is a flat-owning company cannot transition into the LTC regime. The definition of a "flat-owning company" for the purposes of the QC regime, has been extended to apply to the LTC regime following an amendment in s. 154(14) of the *Annual Rates Tax Act*. A flat-owning company means a company:
    (a) Whose constitution provides that every registered shareholder is entitled to the use of a specific residential property in New Zealand owned by the company; and
    (b) Whose only significant assets are: residential properties available for use by specific shareholders, and funds reserved for meeting the company's costs.

14. A flat-owning company could simply remain a QC. The Inland Revenue Department (IRD) has stated that existing QCs and LAQCs will be allowed to "continue to use the current QC rules without the ability to attribute losses, pending a review of the dividend rules for closely held companies". [*Tax Information Bulletin* Vol 23, No1 February 2011, page 46]

15. A QC that is a flat-owning company could transition into a limited partnership using the transition concession. This is not likely to be straightforward from a non-tax legal perspective. It is also not straightforward from a tax perspective: all partners must have the same net opening position as the shareholders in the QC would have upon a notional liquidation of the QC at the end of the year *before* the year in which the transition takes place.

16. The transition concession applies only for the first 2 income years commencing on or after 1 April 2011, so the issues need to be thought through sooner rather than later.

2.4 QCs vs. LTCs: Key Points

(a) Ownership requirements

(Refer to pages 5 to 8 of the attached PDF on *QC/Partnership/LTC Comparison*)

17. There are a couple of differences in the shareholding requirements as between a QC and an LTC. The rules on the rights carried by shares are stricter for an LTC (as they were for LAQCs) than for a QC.

18. For a QC, shareholders who are relatives within the first degree of relationship are treated as one person. For an LTC, shareholders who are relatives within the second degree of relationship are treated as one person.

19. Amendments contained in s. 154(34), (35) & (45) of the *Annual Rates Tax Act* limit the meaning of "relative" for the purposes of aggregating interests in an LTC, by excluding a person connected with another person by being the trustee of a trust under which a relative has benefited or is eligible to benefit. The amendments apply to an LTC from the LTC's first income year beginning after 2 November 2012, the date of assent.

20. Trustees are not counted as shareholders in a QC. A trustee cannot be a shareholder in the QC unless all dividend income from the QC (excluding non-cash dividends) is distributed as beneficiary income. By contrast, a trustee can be a shareholder in an LTC, and is counted, if not all LTC income has been distributed to beneficiaries in the year of counting and the preceding three years.

21. There are specified requirements regarding the rights carried by shares in a LTC, just as there were for an LAQC (Section HA 10 before its repeal). However, there are no specified requirements for rights carried by the shares in an ordinary QC.

22. As already noted (in paragraph 13), flat-owning companies cannot be LTCs, but they can remain QCs.

23. The shareholders in a QC are liable for the income tax of the QC, whereas LTC owners are liable only for their own income tax.

(b) Income and deductions

(Refer to pages 16 and 5 of the attached PDF on *QC/Partnership/LTC Comparison*)

24. The main difference between a QC and an LTC is: that the QC is taxed as a company and pays dividends, whereas an LTC is a look-through entity, and its owners are liable for income tax in their own right, on income and deductions attributed from the LTC.

25. There are no restrictions on foreign dividend income or CFC or FIF holdings for an LTC, whereas restrictions apply to a QC.

(c) Tax rate

(Refer to page 17 of the attached PDF on *QC/Partnership/LTC Comparison*)

26. The company tax rate applies to a QC. Dividends are taxable only to the extent they are fully imputed, at the shareholders' relevant marginal rates. Unimputed dividends are exempt income in the hands of shareholders.

27. An LTC's shareholders are taxed on gross income less allowed deductions from the LTC at their relevant marginal rates.

(d) Loss attribution

(Refer to pages 19 – 22 of the attached PDF on *QC/Partnership/LTC Comparison* and paragraphs 115 to 118 under **Latest Developments**)

28. QC losses can no longer be attributed to shareholders.

29. LTC deductions are attributed to owners, but can only be deducted if the owner has a sufficient owner's basis - the "deduction limitation" rules. These rules limit the extent to which deductions that are attributed by LTCs to their owners can be claimed as deductions by their owners. Refer paragraphs 117 to 118 under **Latest Developments** for the changes contained in the *Annual Rates Tax Act* to measuring "secured amounts" when valuing "Investments" for the purposes of the LTC deduction limitation rules.

(e) QC and LTC interest deductions

(Refer to page 23 of the attached PDF on *QC/Partnership/LTC Comparison* and paragraphs 129 to 133 under **Latest Developments** and the attached PDF on *Interest deductibility by LTCs*)

30. Interest deductibility by QCs requires a nexus with income under the general permission in section DA 1. However, the capital limitation in section DA 2 does not apply. QCs are not allowed an automatic deduction for interest.

31. An LTC is allowed a deduction for interest for money borrowed for the purposes of deriving its assessable income. The Commissioner has clearly stated in QB 11/03 *Income tax: Look-through companies and interest deductibility* that the use of borrowed funds by an LTC owner in a personal capacity is separate from the use of such funds in their capacity as LTC owner.

32. The Commissioner has discussed LTC interest deductions in two further "Questions We've Been Asked": QB 12/08 *Look-through companies: interest deductibility on funds borrowed to repay shareholder current accounts* and QB 12/09 *Look-through companies: interest deductibility where funds are borrowed to make a payment to shareholders to reflect an asset revaluation*.

33. In these QBs the Commissioner maintains that the rules governing interest deductibility in partnerships, as set out in the Australian case of *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4 and discussed in the commentary to Public Rulings *BR Pub 10/14 – 10/19*, are

relevant in determining LTC interest deductions that can be attributed to LTC owners. Refer to paragraphs 129 to 133 under **Latest Developments** for more on this.

(f) Shareholder interest deductions

(Refer to page 24 of the attached PDF on *QC/Partnership/LTC Comparison*)

34. Interest deductions of QC shareholders, on money borrowed to acquire shares in the QC, must be reduced by non-cash dividends received. This does not apply to LTC owners.

35. The Commissioner's statement in QB 11/03 *Income tax: Look-through companies and interest deductibility* that "the LTC regime does not operate to substitute the owner's actions for those of the LTC" clearly implies that an amount borrowed by an owner to invest in an LTC will not be regarded as an amount borrowed by the LTC itself. Therefore an LTC owner should be able to deduct interest on money borrowed to invest in an LTC if that meets the general permission requirements in section DA 1. The capital limitation in section DA 2 will not apply. The deduction limitation rules only apply to deductions attributed from LTCs, so they will not apply to an owner's interest deductions in a personal capacity.

(g) Payments to shareholder-employees

(Refer to page 29 of the attached PDF on *QC/Partnership/LTC Comparison*)

36. There are no special rules governing payments to a shareholder-employee in a QC. There are specified rules on the employment contract between a working owner and an LTC, in order for payments to the working owner to be deductible.

37. The PAYE rules do not apply to income from employment derived by a shareholder-employee in a QC if:

(a) They do not derive salary or wages of a regular amount for regular pay periods:
   (i) Of one month or less throughout the income year; or
   (ii) That total 66% or more of their annual gross income as an employee for the year; or

(b) An amount is paid as income that may later be allocated to them as an employee for the income year.

38. Such income remains employment income for the purposes of other provisions in the Act and an amendment in the *Annual Rates Tax Act* clarifies that. (See page 29 of the attached PDF on *QC/Partnership/LTC Comparison*)

39. The PAYE rules apply to payments from an LTC to a working owner. The payments are included in the working owner's salary or wages.

40. A benefit provided by a QC to an employee under the FBT rules is a fringe benefit and will be subject to FBT. By contrast, FBT will not apply to fringe benefits received by a "working owner" of an LTC. Amendments contained in s. 154(9) & (10) of the *Annual Rates Tax Act* exclude a "working owner" from being an employee for FBT purposes and exclude an LTC from being an employer of a "working owner" for FBT purposes. The amendments apply from the beginning of the LTC regime on 1 April 2011.

41. The cost of providing a fringe benefit as well as the FBT paid is tax deductible to a QC. By contrast, the cost to an LTC of providing a benefit to a working owner is a distribution of profit to the working owner, to the extent of the private use element. The private use costs are non-deductible to the other owners.

(h) Attribution of income to a working person

(Refer to page 30 of the attached PDF on *QC/Partnership/LTC Comparison*)

42. Both a QC and an LTC are required to attribute income to a working person if the criteria for attribution are met. A QC, however, is able to limit a working person's interest and/or penalties by transferring overpaid provisional tax to the working person.

43. By contrast, a working owner of an LTC is paid salary or wages from which PAYE tax is deducted. Under section CE 8, the attributed amount is allocated to the income year in which it is attributed. This would result in a provisional tax obligation for the working person, and the other LTC owners will be entitled to refunds of overpaid provisional tax. There is no mechanism whereby such overpayments could be transferred to the working person.

(i) Dividends and capital reductions

(Refer to pages 33 - 34 of the attached PDF on *QC/Partnership/LTC Comparison*)

44. Dividends paid by QCs are subject to company law rules, as are distributions (dividends) from an LTC to an owner.

45. The general rules on capital reductions apply to QCs. Pro rata capital reductions by an LTC will reduce the owner's basis of LTC owners. A non-pro rata capital reduction by an LTC is treated as a disposal of the owner's interests, and the rules for disposals of owners' interests will apply. Company law rules on capital reductions apply to both QCs and LTCs.

(j) Losing status

(Refer to page 36 of the attached PDF on *QC/Partnership/LTC Comparison*)

46. If QC status is lost, the consequence is that the shareholding continuity rules apply to the carry forward of remaining imputation credits as if they had always applied. Therefore, all remaining imputation credits must be extinguished by corresponding debits to the extent that the required 66% shareholding continuity has not been maintained in respect of those credits. There could be significant tax consequences for LTC owners if LTC status is lost. (See page 36 of the attached PDF on *QC/Partnership/LTC Comparison*)

2.5 QCs vs. Partnerships: Key Points

(a) Ownership requirements

(Refer to pages 5 to 8 and 12 of the attached PDF on *QC/Partnership/LTC Comparison*)

47. A key difference between a QC and a partnership is that there is no restriction on the number of people, or the type of person, who can be partners. However, it is possible for a QC to have a single owner, whereas a partnership must have at least two partners. (Note: there are proposed restrictions on the type of persons who can be general partners of a

limited partnership contained in the Companies and Limited Partnerships Amendment Bill – refer to paragraphs 108 - 112 under **Companies and Limited Partnerships Amendment Bill**.)

48. Amendments contained in s. 154(34), (35) & (45) of the *Annual Rates Tax Act* limit the meaning of "relative" for the purposes of aggregating interests in an LTC, by excluding a person connected with another person by being the trustee of a trust under which a relative has benefited or is eligible to benefit. The amendments apply to an LTC from the LTC's first income year beginning after 2 November 2012, the date of assent. A similar amendment contained in s. 85(5) of the *Annual Rates Tax Act* similarly limits the meaning of "relative" for the purposes of determining a "partner's associate". This amendment came into force on 1 April 2012.

(b) Income and deductions

(Refer to pages 16 and 19 - 22 of the attached PDF on *QC/Partnership/LTC Comparison*)

49. The income and deduction distinctions between a QC and a partnership are the same as those already noted between a QC and an LTC. There are no income restrictions for a partnership. The individual partners are taxed on income and deductions from the partnership. The deduction limitation rules only apply to limited partners. (Refer to paragraphs 115 to 119 under **New Developments** for the latest changes in the limited partnership deduction limitation rules.

(c) Partnership interest deductions

(Refer to page 23 of the attached PDF on *QC/Partnership/LTC Comparison*)

50. The Commissioner has set out the rules governing interest deductibility in partnerships, essentially taken from the judgment in the Australian case of *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4 in Public Rulings *BR Pub 10/14 – 10/19*. Refer to paragraph 131 under **Latest Developments** for more on this.

(d) Partners' interest deductions

(Refer to page 24 of the attached PDF on *QC/Partnership/LTC Comparison*)

51. Partners' interest deductions on money borrowed to invest in the partnership are not reduced by benefits in kind received from the partnership, as is the case with shareholders in a QC.

52. A partner or a limited partner should be able to deduct interest on money borrowed to invest in a partnership or limited partnership if that meets the general permission requirements in section DA 1. The capital limitation in section DA 2 will not apply. The deduction limitation rules only apply to deductions attributed from limited partnerships, so they will not apply to a limited partner's interest deductions in a personal capacity.

(e) Working partners

(Refer to page 29 of the attached PDF on *QC/Partnership/LTC Comparison*)

53. Payments to a working partner are included in the working partner's salary or wages from which PAYE tax must be deducted. Refer to the comments in paragraphs 36 to 38 for the treatment of employment income paid to a shareholder-employee of a QC.

54. There are specified requirements for the service contract between a working partner and a partnership, in order for payments to the working partner to be deductible.

55. Benefits in kind provided to a working partner are not subject to FBT.

(f) Attribution of income to a working partner

(Refer to page 30 of the attached PDF on *QC/Partnership/LTC Comparison*)

56. The situation is similar to that for an LTC. Refer to paragraphs 42 and 43.

(g) Distributions

(Refer to pages 33 - 34 of the attached PDF on *QC/Partnership/LTC Comparison*)

57. Company law governs the payment of dividends by a QC. The *Limited Partnerships Act 2008* ("LPA") governs distributions by a limited partnership. A pro rata reduction in partners' contributions is a distribution under section 38 of the LPA, and will reduce a partner's basis. The disposal rules should apply to a non-pro rata reduction in a partner's interest. The disposal rules also apply when a partnership is dissolved.

2.6 LTCs vs. Partnerships: Key Points

58. The LTC tax regime has been modeled on the tax regime for limited partnerships, but there are some differences.

(a) Ownership requirements

(Refer to pages 5 to 8 of the attached PDF on *QC/Partnership/LTC Comparison*)

59. The main difference is that an LTC can have a single owner, but a partnership must have at least 2 partners. Additionally, any person may be a partner or a limited partner, whereas there are restrictions on who can be a look-through counted owner of an LTC. (Note the proposed restrictions on general partners in a limited partnership referred to in paragraphs 111 onwards.)

(b) Change of status

(Refer to page 36 of the attached PDF on *QC/Partnership/LTC Comparison*)

60. An LTC can change its status and become an ordinary company if the election(s) to be an LTC are revoked. Such an option is not available to a limited partnership.

(c) Income and deductions

(Refer to pages 16 & 19 - 22 of the attached PDF on *QC/Partnership/LTC Comparison*)

61. LTC owners are taxed on income and deductions from the LTC. Similarly, the individual partners in a partnership are taxed on income and deductions from the partnership.

62. For an LTC, the deduction limitation rules apply to all the LTC's owners. However, for a limited partnership the deduction limitation rules only apply to the limited partners. The deduction limitation rules do not apply to an ordinary partnership.

63. The extent to which FIF dividends are included in an LTC owner's or limited partner's "Income" for the purpose of calculating the owner's basis has been clarified. Refer to paragraphs 115 to 116 under **Latest Developments** for the details.

64. When calculating an LTC's owner's basis, loans made to the LTC by the owner are included as "Investments". An amendment contained in s. 85 of the *Annual Rates Tax Act* to the definition of a "capital contribution" by a limited partner clarifies that loans made by a limited partner to a limited partnership similarly also qualify as "investments" when calculating the partner's basis. The amendment applies from 1 April 2008.

65. Refer to paragraphs 117 to 118 under **Latest Developments** for the changes contained in the *Annual Rates Tax Act* to measuring "secured amounts" when valuing "Investments" for the purposes of both the LTC and limited partnership deduction limitation rules.

(d) Distributions

(Refer to pages 33 - 34 of the attached PDF on *QC/Partnership/LTC Comparison*)

66. "Distributions" from an LTC are defined as:

"the market value of distributions to the person from the LTC, including loans made to the person from the LTC and payments to which section DC 3B (payments to working owners) does not apply."

67. For a limited partnership, "distributions" are:

"the total of -

(a) the market value of distributions to the partner from the limited partnership:

(b) the amount paid to the partner for the assignment of capital contributions by them."

68. A pro rata capital reduction, in the case of an LTC, or a pro rata reduction in partnership interests in the case of a partnership, should be regarded as a distribution, but this conclusion is reached more easily with the LTC definition of "distributions". A reduction in a partner's interest is a distribution from a limited partnership under section 39 of the *Limited Partnerships Act 2008*.

69. A non-pro rata reduction in an LTC owner's interest is specifically deemed to be a disposal of the owner's LTC interest, but that is not the case with a reduction in an individual partner's contribution to a limited partnership. A reduction in a partner's contribution may well be a disposal under the general framework of Subpart HG depending on the contractual basis on which the contribution is reduced.

(e) Working owners

(Refer to page 29 of the attached PDF on *QC/Partnership/LTC Comparison*)

70. An existing difference between an LTC and a partnership, is that a working owner in LTC can be subject to FBT, where is a working partner in a partnership is not.

71. This anomaly has been corrected by amendments to the definitions of "employee" and "employer" contained in s. 154(9) & (10) of the *Annual Rates Tax Act*, which clarify that a "working owner" of an LTC is not treated as an employee for FBT purposes. The amendments apply from 1 April 2011.

(f) Apportionment of imputation and FDP credits

(Refer to page 17 of the attached PDF on *QC/Partnership/LTC Comparison*)

72. The imputation and FDP credits apportioned to a partner must be in proportion to the partner's share of the income from the partnership. There is no such stipulation for imputation or FDP credits allocated to an LTC owner (but this should happen anyway, as all shares in an LTC must have equal rights).

(g) Agent of absentee partner

(Refer to page 10 of the attached PDF on *QC/Partnership/LTC Comparison*)

73. A partner in a partnership, or a general partner in a limited partnership, is treated as the agent of an absentee partner, or limited partner, respectively, in relation to the absentee's share of partnership income.

74. There is no such agency provision that applies to LTC owners.

(h) Anti-avoidance

(Refer to page 31 of the attached PDF) on *QC/Partnership/LTC Comparison*)

75. Excessive income derived by an LTC owner who is under 20 years old and a relative of another LTC owner can be re-allocated. There is no equivalent rule for a partnership.

76. The market value can be substituted for the actual consideration in relation to an arrangement entered into by a partner that has the purpose or effect of defeating the intent and application of the partnership tax regime. There is no equivalent rule that applies in relation to LTCs.

(i) Corporate law differences

(Refer to pages 5 & 6 of the attached PDF on *QC/Partnership/LTC Comparison*)

77. The *Companies Act 1993* applies to an LTC. The *Limited Partnerships Act 2008* applies to a limited partnership, and the *Partnership Act 1908* applies to ordinary partnerships.

2.7 The New Look-through Company (LTC) Tax Regime: Summary

78. The new LTC tax regime applies from income years commencing on or after 1 April 2011.

79. There are no tax consequences if a QC transitions to an LTC in either the 1st or 2nd income year beginning on or after 1 April 2011. Otherwise, the LTC owners will have income, from deemed dividends arising from a notional liquidation of the transitioning company. (Refer to pages 12 to 15 and 26 of the attached PDF on *QC/Partnership/LTC Comparison*.)

(a) Requirements to elect into the regime

(Refer to pages 5 - 9 & 11 of the attached PDF on *QC/Partnership/LTC Comparison*)

80. An LTC need not be a company. The requirement is that it should have a legal existence separate from that of its members. Therefore, for example, a limited partnership could elect to be an LTC *for tax purposes*, provided the other requirements are met.

81. The tax regime is very similar to that of a limited partnership. An LTC must file a tax return, but it is the individual LTC owners that are subject to tax. Hence an LTC will not maintain an ICA.

82. Only natural persons or corporate trustees can be LTC owners, although an LTC can be owned through another LTC.

83. They can only be five or fewer owners of an LTC. The rights carried by every share in an LTC must be identical, so that income distributions are decided in proportion to the shares held.

(b) LTC income and deductions

(Refer to pages 15, 19 - 22 & 36 of the attached PDF on *QC/Partnership/LTC Comparison*)

84. An LTC owner's proportionate allocation, of the LTC's income and deductions, is based on the owner's daily average interest in the LTC for the year. However, if an LTC's income is at least \$3 million, the owners can choose to base allocations on owners' interests at particular times during the year, provided that this method of allocation is used by all LTC owners. The Commissioner can require that allocations be based on an owner's interests at particular times during the year if an LTC's income is at least \$3 million.

85. An LTC's gross income is attributed to its owners in the same way as a partnership's income is attributed to the partners.

86. A net loss of an LTC is attributed to the owners, by attributing LTC deductions in excess of LTC gross income. But the ability of the owners to deduct that loss is restricted. An owner's attributed deductions from an LTC for a year, can only be deducted to the extent of the "owner's basis" at the end of that year.

87. The owner's basis is a means of limiting LTC deductions in excess of LTC income, to the amount of the owner's net investment in the LTC (i.e. investment net of LTC distributions).

88. LTC deductions in excess of LTC income progressively reduce the owner's basis, until it is equal to the gross income from the LTC each year. Once that happens, the owner's LTC deductions are limited to income from the LTC for the year.

89. LTC deductions that are not allowed due to an insufficient owner's basis, can be carried forward and used in a later year when there is a sufficient owner's basis.

90. If an LTC ceases to exist, or ceases to be an LTC, any remaining excess deductions are lost.

(c) Distributions

(Refer to pages 33 - 34 of the attached PDF on *QC/Partnership/LTC Comparison*)

91. Distributions reduce an owner's basis. LTC distributions include all payments by the LTC that are not payments to a working owner.

92. A distribution by way of a share repurchase is treated as a disposal of part of an owner's interest and the rules for disposals apply.

(d) Valuation of an owner's investment in an LTC

(Refer to pages 19 - 20 & 12 of the attached PDF on *QC/Partnership/LTC Comparison*)

93. The valuation of an owner's investment in an LTC is an important aspect of determining the owner's basis. The general rule is that an owner's investment is: the market value of the owner's shares in the LTC at the time they were acquired, plus loans made to the LTC plus "secured amounts". Amendments in s. 80(1) & (4) of the *Annual Rates Tax Act* have clarified how "secured amounts" are to be calculated. Refer to paragraphs 117 to 118 under **Latest Developments** for more on this.

94. There is a valuation alternative under the QC transition concession: the accounting book value of an owner's shares in the QC at the time of the transition from a QC. Amendments in s. 112(1) & (2) of the *Annual Rates Tax Bill* have clarified that once a valuation is adopted it cannot be changed. Refer to paragraph 114 under **Latest Developments** for more on this.

(e) Deduction of an owner's interest expenditure

(Refer to page 24 of the attached PDF on *QC/Partnership/LTC Comparison*)

95. The deductibility of an owner's interest expenditure, on money borrowed to acquire shares in an LTC, is not affected by the owner's basis. This is because the interest deduction is not an LTC attributed deduction.

96. The Commissioner's statement in QB 11/03 *Income tax: Look-through companies and interest deductibility* that "the LTC regime does not operate to substitute the owner's actions for those of the LTC" clearly implies that an amount borrowed by an owner to invest in an LTC will not be regarded as an amount borrowed by the LTC itself. Therefore an LTC owner should be able to deduct interest on money borrowed to invest in an LTC if that meets the general permission requirements in section DA 1. The capital limitation in section DA 2 will not apply. The deduction limitation rules only apply to deductions attributed from LTCs, so they will not apply to an owner's interest deductions in a personal capacity.

(f) Deduction of losses carried forward from a QC

(Refer to page 25 of the attached PDF on *QC/Partnership/LTC Comparison*)

97. Losses carried forward from a QC are attributed to an LTC's owners. The ability to deduct such losses is not limited by the owner's basis. However, the losses can only be set off against income from the LTC: either net income from an LTC, or income from the LTC that has resulted due to LTC deductions disallowed because of an insufficient owner's basis.

(g) Payments to a working owner

(Refer to pages 29 - 32 of the attached PDF on *QC/Partnership/LTC Comparison*)

98. A deduction for payments to a working owner is only permitted if there is a contract of employment, in writing that specifies the terms and conditions and the amount payable, and is signed by all parties.

99. Fringe benefits provided to a working owner will not be subject to FBT under amendments to the definitions of "employer" and "employee" contained in s. 154(9) & (10) of the *Annual Rates Tax Act*. The amendments apply from 1 April 2011.

100. An LTC is treated as a separate taxpayer when applying the income attribution rules in sections GC 27 to 29.

(h) Treatment of disposals and safe harbour rules

(Refer to pages 37 - 39 of the attached PDF on *QC/Partnership/LTC Comparison*)

101. A payment to an LTC owner, for a disposal of the owner's interest in the LTC, may be taxable on general principles, subject to the application of specified safe harbour limits.

102. The general safe harbour rule is that the gain on disposal, (calculated using the tax book values of revenue account property, depreciable property and financial arrangements), must be less than $50,000. There are also specific safe harbour rules. (Refer to pages 38 & 39 of the attached PDF on *QC/Partnership/LTC Comparison*.)

(i) Tax filing obligation and tax disputes process

(Refer to pages 11 & 40 - 42 of the attached PDF on *QC/Partnership/LTC Comparison*)

103. An LTC has to file an annual tax return, showing the income and deductions of the LTC, and the allocations to the LTC's owners.

104. An amendment in s. 78 of the *Annual Rates Tax Act* clarifies that elections concerning the tax treatment of an LTC's income or property, or any valuation or timing methods adopted in relation to an LTC's income or property, are made or established by the LTC, not each owner. The elections made, or valuation and timing methods adopted, by the LTC are then binding on the owners in respect of their look-through interests in the LTC's property. The amendment applies from 1 April 2011.

105. Only an LTC may propose adjustments in a NOPA and complete the disputes process in connection with a tax position taken in an LTC's tax return. An owner can challenge an assessment relating to income from an LTC once the LTC has completed the disputes process.

106. The LTC's tax return is treated as if it were a return by each owner for the purpose of applying shortfall penalties for an unacceptable tax position. An LTC could also possibly be regarded as a "group of persons", under section 94B of the *Tax Administration Act 1994*, for the purpose of applying shortfall penalties generally to LTC owners in proportion to their interests in the LTC.

(j) GST grouping

107. LTCs will be able to use the GST group registration rules under an amendment contained in s. 223(1) of the *Annual Rates Tax Act*. The amendment applies from 1 April 2011.

3. COMPANIES AND LIMITED PARTNERSHIPS AMENDMENT BILL

(See also pages 6 & 7 of the attached PDF on *QC/Partnership/LTC Comparison*)

108. The *Companies and Limited Partnerships Amendment Bill* was reported from the Commerce Committee on 11 December 2012. The Commerce Committee recommended as follows:

"We recommend that the requirements for an agent living in New Zealand in Part 1 subpart 2 (concerning companies) and Part 2 subpart 1 (concerning limited partnerships) be omitted. Better balance could be achieved by requiring a company to have a director who lives in New Zealand, or who lives in and is a director of a company in a country with which New Zealand has reciprocal arrangements for the enforcement of low-level criminal fines. Similar requirements are inserted for limited partnerships. We recommend inserting new clauses 22B and 52A to make transitional provisions for these changes.

The purpose of requiring a director who lives in New Zealand is to ensure that there is an identifiable individual with a substantive connection with the company who can be questioned about the activities of the company, and who can in certain circumstances be held to account. The requirement would provide a broad, practical, non-technical test for the Registrar to apply. A person would not be required to be a New Zealand citizen or to hold an appropriate visa before they could be a director who lives in New Zealand, although the person's residence status would probably be relevant to the Registrar's consideration in appropriate cases.

The option of appointing an agent who lives in New Zealand was intended to provide an alternative with lower compliance costs for overseas-based New Zealand companies, but we consider that such agents would be of limited help to enforcement agencies and in many cases would not be accountable for the actions of the company. We therefore consider that the requirement for an agent living in New Zealand would provide only limited deterrence from the misuse of companies and limited partnerships.

We have considered the costs of this requirement and believe that most companies and limited partnerships already comply."

109. Under proposed s. 8(4) contained in clause 46 of the *Companies and Limited Partnerships Amendment Bill*, a limited partnership must have one or more of the following:

(a) A general partner who is a natural person and who:

(i) Lives in New Zealand; or

(ii) Lives in an enforcement country and is a director of a company that is registered (except as the equivalent of an overseas company) in that enforcement country; or

(b) A general partner that is a partnership governed by the *Partnership Act 1908* that has at least one partner who is a natural person living in New Zealand or in an enforcement country; or

(c) A general partner that is a company registered on the New Zealand register under the *Companies Act 1993*.

110. Until now, any person may be a partner of any partnership. This will continue to apply in relation to a limited partner of a limited partnership under proposed s. 18(1A) in clause 47 of the *Companies and Limited Partnerships Amendment Bill*.

111. Qualifications are to be introduced in new s. 19A & 19B contained in clause 48 of the *Companies and Limited Partnerships Amendment Bill*, in relation to general partners of limited partnerships. A general partner must be:

- A natural person who is not disqualified due to being under 18 or an undischarged bankrupt or prohibited from being a general partner or a director for other reasons specified in proposed new section 19A(2) of the *Limited Partnerships Act 2008*; or
- A partnership governed by the *Partnership Act 1908* with at least one partner who is not disqualified under section 19A(2); or
- A company registered under the *Companies Act 1993*, in relation to which the similar requirements will apply to directors.

112. Transitional provisions will apply relating to the requirement for 1 or more general partners to live in New Zealand, etc.:

(a) Under clause 52A of the *Companies and Limited Partnerships Amendment Bill* the new rules in proposed s. 8(4) and described in paragraph 109 above will not apply until 6 months after enactment.

(b) Within 6 months after enactment, a limited partnership must arrange for a general partner who complies with the requirements in s. 8(4), and comply with the notification and other requirements in clause 52A of the *Companies and Limited Partnerships Amendment Bill*. Under clause 52B, an existing limited partnership must provide the Registrar with the place of birth of each partner who is a natural person.

4. LATEST DEVELOPMENTS

4.1 Legislation changes in the *Annual Rates Tax Act*

113. There are a number of legislative changes that have affected the operation of the LTC tax regime, and to a lesser extent, the limited partnership tax regime.

QCs transition into partnership or LTC

114. Effective from 1 April 2011, the calculation of the initial owner's basis for a concessional transition of a QC into either a partnership or LTC is to be clarified so that:

(a) The initial basis chosen applies to the transitional income year and all later income years.

(b) The option of using "market value or accounting book value… as at the end of the income year before the transitional income year" applies:

(i) Specifically for the valuation of the QC shares held at the end of the income year before the transitional income year; and

(ii) Only for the purpose of valuing the item "Investments" in the owner's basis calculation – i.e. capital contributions made by a partner in a limited partnership, or shares purchased or subscribed for in an LTC.

(Previously the market value or accounting book value option applied to all the "amounts" in the owner's basis calculation, and the item to be valued – the QC shares – was not specified.)

[Reworded opening paragraph to sections HZ 4B(5) & HZ 4C(2) and Replacement sections HZ 4B(5)(a) & HZ 4C(2)(a) effective from 1 April 2011 in s. 111 & s. 112 and 2(27) of the *Annual Rates Tax Act*]

FIF Income

115. The following rules apply to a person with an effective look-through interest in an LTC (an LTC owner) from 1 April 2011, and to a limited partner in a limited partnership retrospectively from 1 April 2008.

116. The extent to which FIF dividends are included in a person's "Income" for the purpose of calculating the person's owner's basis has been clarified. Dividends received from FIFs, that are treated as not being dividends under section CD 36(1), are included in the calculation of "Income" based on the following rules:

(a) If the person's share of FIF dividends is less than the FIF income of the person, the FIF dividends are ignored.

(b) If the person's share of FIF dividends exceeds the person's FIF income, the dividends are included in "Income" to the extent of the excess.

(c) If the person has a FIF loss, the person's "Income" includes the whole of the person's share of FIF dividends.

[Replaced section HB 11(7)(a) & (ab) and new sections HB 11(7B) & (7C) effective from 1 April 2011, and replaced section HG 11(7)(a) & (ab) and new sections HG 11(7B) & (7C) in s. 80(2) & (3) and 85(1) & (2) and s 2(27) & (11) of the *Annual Rates Tax Act*]

Secured amounts changes

117. The following rules apply to a person with an effective look-through an LTC (an LTC owner) from 1 April 2011 and to a limited partner in a limited partnership from 1 April 2012.

118. The extent to which "secured amounts" are allowed to be included in "Investments" for the purpose of calculating an owner's basis is being limited as follows:

(a) "Secured amounts" will not include an amount that the LTC is debtor for in relation to another person if that other person has included that amount in that other person's "Investment".

(b) "Secured amounts", for a person, will be limited to the proportion of (LTC or limited partnership) debt that the person (and owner's associates of the person) is guarantor for, taking into account all third party guarantors for the same debt.

(c) Where a guarantee or indemnity expressly provides recourse only to certain property, the "secured amount" will be limited to the proportional interest in the market value of the recourse property that the person (and owner's associates of the person) has, net of higher-ranking calls that are actual, future or contingent, taking into account the proportional interests in the recourse property of all third party guarantors.

(d) For this purpose, "owner's associate" refers to persons who are not themselves owners of the LTC or partners in the limited partnership, and are either relatives of the person or a trustee associated – in their capacity as trustee – with the person. A relative does not include a trustee of a trust in which a relative has benefited or is eligible to benefit.

[Replacement section HB 11(12), and new definitions ("guarantor" and "recourse property"), replacement definition ("secured amounts") and amended definition ("partner's associate") in section HG 11(12) inserted by s. 80(4) and s. 2(27), and s. 85(4) to (6) & clause 2(33) of the *Annual Rates Tax Act*]

Capital contribution change in limited partnerships

119. Effective from 1 April 2008, a capital contribution to a limited partnership includes amounts owed to the limited partner by the limited partnership, including a loan to the limited partnership and a credit balance in a current account.

[Replacement definition of "capital contribution" in section HG 11(12) inserted by s. 85(3) and 2(11) of the *Annual Rates Tax Act*]

LTCs and financial arrangements

120. The general rule in section HB 8 is that when an LTC owner disposes of an interest in an LTC, unless the disposal is because the LTC ceases to be an LTC or ceases to exist or the LTC's capital is reduced, the LTC's financial arrangements are ignored, and the entering owner is treated as if they always held the financial arrangement. The exiting owner is not required to perform a base price adjustment.

121. The application of this rule depends on no income being derived from a business of holding financial arrangements. The legislation has been amended so that is clear that it is the LTC that cannot have a business of holding financial arrangements (and not the owners in their personal capacities as a reading of the legislation as it previously existed suggested).

[Amendment to section HB 8(1)(b) in s. 79 of the *Annual Rates Tax Act*]

LTCs and FBT

122. The definitions of "employer" and "employee" have been amended so that FBT will not apply to fringe benefits received by a "working owner". An LTC is excluded from being an employer of a "working owner" for FBT purposes. The amendment applies from 1 April 2011.

[Amendments to the definitions in section YA 1 of "employee" and "employer in s. 154(9) and (10) of the *Annual Rates Tax Act*]

LTCs and Partnerships: benefits provided to associates of employees

123. The anti-avoidance rule in section GB 32, that applies so as to treat a benefit that is provided to a person who is associated with an employee as a fringe benefit provided to the employee will not apply when:

(a) The employer is an LTC or a partnership or a limited partnership; and

(b) The person associated with the employee is an owner of the LTC or a partner in the partnership or limited partnership.

The amendment applies from 2 November 2012, the date of assent of the *Annual Rates Tax Act*.

[New section GB 32(2B) in s. 74 of the *Annual Rates Tax Act*]

LTC Elections

124. The rules on elections and methods that are chosen for tax purposes by an LTC have been clarified. All elections and methods are chosen by the LTC itself, and then those elections and methods apply to the LTC owners when returning income and deductions attributable to them from the LTC.

[New section HB 1(6) inserted by s. 78 of the *Annual Rates Tax Act*]

LTCs GST Grouping

125. Section 55 of the GST Act has been amended so as to allow LTCs to be treated as part of a GST group with other LTCs or other companies.

[Amendment to section 55(1)(a)(iii) of the GST Act in s. 223(1) of the *Annual Rates Tax Act*]

QC amalgamations

126. In order to remain being treated as a QC, a QC must already have been a QC at the end of the income year before the 1st income year that starts on or after 1 April 2011 and must not have amalgamated, on or after 3 November 2012 the date after the date of assent of the *Annual Rates Tax Act*, with another company that is not a qualifying company.

[Amendment to section HA 7B contained in s. 75 of the *Annual Rates Tax Act*]

Amended definition of "relative"

127. The definition of "relative has been amended by excluding a person from being a relative of another person by being a trustee of a trust under which a relative has benefited or is eligible to benefit (paragraph (v) in the definition of "relative" in s. YA 1. This applies:

(a) For the purpose of counting "look-through counted owners" in an LTC from the LTC's first income year starting on or after 3 November 2012, the date after the date of assent of the Annual Rates Tax Act.

(b) For the purpose of determining whether a person is a "partner's associate" from 1 April 2012.

[Amendments to the definition of "relative" in s. YA 1 in s. 154(34), (35) and (45) and s. HG 11(12) in s. 85(5) of the *Annual Rates Tax Act*]

Definition of "flat-owning company applies for LTCs

128. The definition of "flat-owning company in s. YA 1 has been amended so that the definition of "flat-owning company" in s. CD 31(2) applies for LTC purposes. The amendment applies from 1 April 2011.

[Amendment to s. YA 1 contained in s. 154(14) of the *Annual Rates Tax Act*]

4.2 IRD answers to questions on interest deductibility by LTCs and tax avoidance

(Refer to the attached PDF on *Interest deductibility by LTCs*)

129. ***QB 11/03, 12/08 and 12/09*** concern the deductibility of interest on money borrowed by LTCs. The situations are:

(a) *QB 11/03*: Whether interest will still be deductible where a loss-attributing qualifying company (LAQC) becomes a look-through company (LTC) if:

- A person had previously sold their family home, at market value, to a wholly-owned LAQC as a rental asset, to be rented to a third party on an arm's length basis; the purchase was funded by a bank loan that the person used to acquire a new family home; the LAQC has become an LTC.

(b) *QB: 12/08*: An LTC borrows money on arm's length terms to repay current account loans from its shareholders.

(c) *QB 12/09*: An LTC borrows money and uses it to make payments to shareholders reflecting the increase in the value of an income-earning asset it holds.

130. *QB 12/11* is concerned with whether the general anti-avoidance rule in section BG 1 would apply where:

- A person who owns 100% of an LTC sells their family home, at market value, to the LTC;
- The home is used by the LTC as a rental asset and is rented to a third party on an arm's length basis;
- The LTC borrows from a bank to fund the purchase (and pay the person for the sale);
- The person then uses the funds raised from the sale to purchase a new family home;
- The person, in their capacity as holder of an effective look-through interest in the LTC, is able to deduct the interest incurred by the LTC on the loan (QB 11/03 confirms this).

131. The conclusions on interest deductibility in the QBs are consistent with those in Public Rulings 10/14 – 10/19 and the commentary relating to those rulings, in which *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4 ("*Roberts and Smith"*) is discussed. Refer to the attached PDF on *Interest deductibility by LTCs*.

132. However, underlying the conclusions, and *not necessarily immediately obvious, are the significant accounting and record-keeping requirements that arise in relation to payments by an LTC to its shareholders*.

133. The Commissioner's view as stated in *QB 12/11* is that section BG 1 would not apply to the arrangement described. The basis for this is described in the attached PDF on *Interest deductibility by LTCs*.

4.3 Determination of LTC and limited partnership CFC and FIF interests

134. Where an LTC holds a control interest and an income interest in a CFC, the better view is that all shareholders with an effective interest in the LTC hold interests in a CFC (and not in a FIF), regardless of the individual proportionate interests of the LTC owners.

135. The same rule should apply in respect of a limited partner's interest in a CFC held by the limited partnership.

136. The basis for this is s. HB 1(4)(b) in the case of an LTC, and s. HG 2(1)(b) in the case of a limited partnership. These sections state that an LTC owner or a partner, as the case may be*, is treated as holding property that the LTC or partnership, holds* in proportion to the person's effective look-through interest or partner's partnership share. It is the property held by the LTC or partnership that becomes the property held by the LTC owner or partner.

137. Further support for this viewpoint can be obtained from the following:

    (a) Section EX 13 that was repealed effective from 1 April 2008 previously stated that the section applied "when a partnership holds rights that would be an income interest in a CFC if the partnership were an individual." In that case, each partner was treated as holding a share of what was held by the partnership in proportion to the partner's interest in the partnership.

    (b) Section EX 30(8) concerns the calculation of the direct income interest in a FIF for a partnership and states that:

    "In this section, *if a partnership holds any rights*, each partner is treated as holding a share of those rights in proportion to the partner's interest in the partnership." (emphasis added)

    (c) Section 78 of the *Annual Rates Tax Act* has inserted a new section HB 1(6) which states that:

    "*Inland Revenue Act elections and methods relating to an LTC are chosen by the company* ignoring subsection (4), and then subsection (4) applies so that the elections and methods are those of an owner of an effective look-through interest for the look-through company." (emphasis added)

138. It is noted that the CFC and FIF tax regimes contain a number of choices that require elections by the taxpayer. For example, s. 52 of the *Annual Rates Tax Act* provides for an election to an elective attributing CFC.

139. Based on the above, it is the writer's view that you do not look-through an LTC or a partnership to determine whether an owner or partner has a CFC or a FIF interest. For example, an LTC may qualify to use the attributed FIF income (AFI) method due to a

shareholding of at least 10%, whereas an individual owner may not. However, it is the LTC's interest that is relevant. Similarly, an LTC or partnership may hold an interest in a CFC, whereas an individual owner or partner's interest may only amount to a FIF interest if determined directly. In that case, the individual owner or partner's interest remains an interest in a CFC, and not in a FIF.