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WEEKLY COMMENT: FRIDAY 29 JANUARY 2016

1. This week I am re-commencing Weekly Comments for 2016. I am beginning by looking at the proposals in *Closely held company tax issues – An officials' issues paper* ("the CHC Issues Paper"), released on 8 September 2015, over this week and next week. Officials have stated that the "changes are intended to included in the next omnibus tax bill, with most of the changes applying from the beginning of the 2017-18 income year". This week, I am reviewing the proposals relating to:
   (a) LTC entry criteria;
   (b) Shares with different voting rights proposed for a LTC;
   (c) Recommended changes where a trust is a shareholder in a LTC;
   (d) Foreign income and non-resident ownership; and
   (e) The deduction limitation rule for LTCs.

2. The CHC Issues Paper commences with a Table comparing the following various entity types (direct ownership, general partnership, limited partnership, look-through company ("LTC"), loss attributing qualifying company ("LAQC", which is no longer available), qualifying company ("QC"), trust and company) in terms of the following tax characteristics:
   (a) Ownership rules: ownership is restricted to 5 or fewer owners in the case of LTCs and QCs, and a limited partnership must have at least 1 general partner, whereas there are no restrictions on the number of owners for the other entity types;
   (b) Different ownership rules/class of shares: An LTC is unique in the sense that only a single class of share is allowed, whereas all the other entity types may provide for different rights for different owners;
   (c) Owner's liability: Liability is unlimited for direct owners, partners in a general partnership, and for trustees, but is liability is limited for the owners of the other entity types as well as for beneficiaries of trusts;
   (d) Tax rate: owners' marginal tax rates for direct ownership, partnerships, LTCs, beneficiaries of trusts, and shareholders in QCs and in ordinary companies upon distribution of dividends, company tax rate applies to undistributed earnings in QCs and other companies, and trustees are taxed at the top marginal tax rate of 33%;
   (e) Losses: losses are quarantined to the entity for QCs, other companies and trusts, losses are available to shareholders in LTCs and to limited partners in limited partnerships subject to loss limitation rules, and losses are available to owners and partners in a general partnership without limitation;

(f) Capital gains: capital gains are not taxed, but they could be taxed upon distribution by an ordinary company; and

(g) Ownership changes/restructures: ownership changes are not taxed in a trust (where beneficiaries' rights could be changed simply by varying the trust deed), and they are not taxed a QC or in an ordinary company unless the shares are held on revenue account (shareholding continuity requirements apply to the carry forward of tax losses and in ordinary companies also to the carry forward of imputation credits), whereas in direct ownerships, partnerships and LTCs, gains and losses on revenue account and depreciation adjustments are taxable to owners and partners, subject to de minimis rules in the of partnerships and LTCs.

3. One key issue identified with closely held companies is whether tax preferences generated by an entity should be allowed to flow through to the owners of the entity, and if so, whether there should be restrictions on the ability to earn offshore income because when an ordinary company earns tax preferred offshore income this preference is clawed back upon the distribution of that income to shareholders.

4. In the case of ordinary companies, it is noted that capital gains can only be distributed tax-free to shareholders on the liquidation of the company. However, officials note that 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. While officials acknowledge that additional compliance costs are incurred in doing so, they state "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".

LTC entry criteria

5. Table 3 in the CHC Issues Paper compares the entry criteria for LTCs with those for a QC. The differences in company requirements/restrictions are:

(a) A QC cannot earn more than $10,000 per annum of non-dividend foreign income, whereas there is no foreign income restriction for a LTC;

(b) A LTC cannot be a "flat-owning company" as defined in s. CD 31(2), whereas there is no equivalent restriction for a QC – in fact the rule restricting the number of owners is specifically relaxed in s. HA 6 so as to allow a flat-owning company to be a QC;

(c) A LTC can have only a single class of share, whereas a QC is not restricted in that way (a LAQC was restricted to a single class of share, but LAQCs are no longer allowed); and

(d) A QC cannot be part of an arrangement that has the purpose of defeating the intent and application of the QC rules.

6. The differences in shareholder requirements are:

(a) The LTC rules allow "relatives" as defined in s. YA 1 – which includes natural persons linked within the second degree of blood relationship with each other - to be counted as 1 person, whereas the QC rules allow only natural persons linked to 1 degree to be counted as a single person;

(b) In the case of trust shareholders, the QC rules require all dividends derived by a trust to be beneficiary income and for all beneficiaries who received dividends to be counted as the owners, whereas the LTC rules do not require all dividends to be paid as beneficiary income and where all dividends are not beneficiary income the trustee is counted as an owner and only beneficiaries who received dividends in the last 3 income years are counted as owners.

Shares with different voting rights proposed for a LTC

7. Officials "acknowledge that there can be legitimate commercial/generational planning reasons for shares to carry different voting rights".

8. Therefore, they 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.

Recommended changes where a trust is a shareholder in a LTC

9. Officials have raised the following concerns regarding how trusts are measured as LTC owners:

   (a) The fact that only beneficiaries who received dividends in the last 3 years are counted as owners means that a trust could rotate beneficiaries who receive dividends and potentially circumvent the "five or fewer owners" rule;

   (b) Dividends could be retained by a trustee and distributed to beneficiaries in a subsequent year, which would avoid such beneficiaries being counted as owners of the LTC;

   (c) A company that is not itself a LTC is prohibited from being LTC owner, whereas such a company is not currently prohibited from benefiting from a LTC by being a beneficiary of a trust that owns a LTC;

   (d) Charities and Maori authorities could have a wide range of beneficiaries and potentially circumvent the "five or fewer owners" rule.

10. Officials have recommended the following changes to counter these potential breaches:

    (a) Firstly, a beneficiary that receives any distribution from the trust in the past 6 years – whether the distribution be beneficiary income or be any other trust distribution - sourced from prior year trustee income, corpus or capital;

    (b) Second, the trustee would also be counted as an owner if not all income – from all income sources and not just from the LTC – is distributed for the relevant period;

    (c) Thirdly, where a trust has a corporate (non-LTC) beneficiary, LTC status would cease from the beginning of the income year in which a distribution is made to the corporate beneficiary; and

    (d) Fourth, charities and Maori authorities would automatically be precluded from being shareholders in a LTC or beneficiaries of a shareholding trust.

11. The recommendation to use 6 years is apparently "to match the time period with that generally applying to claims under the *Limitation Act 2010* as trustees are required to keep records for at least that time in case a beneficiary challenges a distribution decision".

12. In the case of a distribution to a corporate beneficiary, the loss of LTC status would occur in the year the distribution is made, which, in the case of beneficiary income, could be the year following the year in which the beneficiary income is derived. If the loss of status occurred in the year the beneficiary income is earned there would be additional compliance costs in adjusting past tax payments and returns. Therefore, officials prefer to treat all distributions the same and to base the loss of status on the year of the distribution.

13. In the case of charities, the rule to exclude them would apply regardless of whether or not the charity is a trust. However, in order to preserve the ability of a trust to make charitable donations, officials have suggested an explicit safe harbor rule that would allow a shareholding trust to donate up to 10% of the net income it receives from a LTC in any given year to charitable entities.

14. In the case of Maori authorities, it is noted that an implication of the recommendation to exclude them from being shareholders in a LTC will be that their separate corporate business activities would be taxed at the company tax rate of 28%, as opposed to the Maori authority rate of 17.5%.

Foreign income and non-resident ownership

15. Officials have raised the following potential concerns relating to the facts that at present there is no restriction on foreign income earned by a LTC or on a LTC having non-resident shareholders.

16. Where a non-resident invests in New Zealand assets through a LTC, there could be hybrid entity mismatches because the LTC is treated as a look-through vehicle in New Zealand but is treated as a company in the non-resident's country of residence. This is currently the case when an Australian resident invests in NZ through a LTC. The OECD is developing recommendations to deal with hybrid mismatches, and officials have stated that NZ is looking at the suitability of implementing the recommendations. No measures are currently proposed to deal with this concern.

17. Where a New Zealand resident invests offshore through a LTC, the LTC's foreign income is included in the NZ resident's income and any foreign tax paid gives rise to a foreign tax credit available to the shareholder. Whereas when the foreign income is earned through a NZ company the shareholder is unable to use the foreign tax credit because there are no corresponding imputation credits generated. Another potential concern identified is that foreign branch losses incurred through a LTC can be included in the NZ resident's income, but when the foreign branch becomes profitable, it could be converted into a separate company and excluded from the LTC's income. However, officials note that only a very small proportion of LTCs earn foreign income, so no measures are currently proposed to deal with concerns relating to foreign investments through LTCs by New Zealand residents.

18. Where a non-resident invests in foreign assets through a New Zealand LTC ("conduit investments"), officials note that there are reputational risks and some revenue risks:

    (a) The revenue risks are not regarded as major, because non-residents cannot deduct their share of a LTC's New Zealand interest expenses incurred to derive foreign income and such interest deductions are subject to the thin capitalisation rules in any case.

    (b) Officials consider it appropriate to deal with the reputational risk and have proposed that when more than 50% of the shareholding in a LTC is held by non-residents, the LTC's total annual foreign income (including foreign dividends and foreign interest income) would be restricted to the greater of $10,000 or 20% of the LTC's gross income, and if this condition is breached, LTC status would be revoked for that income year and any subsequent year that the condition was not met.

The deduction limitation rule for LTCs

19. The deduction limitation rule for look-through companies ("LTCs") limits a LTC owner's tax deductions from the LTC to their "owner's basis", which is supposed to represent the amount they have invested in the business. Officials note that the rule was initially developed for limited partnerships which "straddle the dichotomy between partnerships and widely held companies, with no limits on the number of persons who can be members". Officials note further that:

    "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."

20. However, officials distinguish between LTCs and limited partnerships on the grounds that:

    (a) Limited partnerships were introduced to facilitate in-bound venture capital, whereas LTCs are targeted at closely controlled businesses, primarily with a domestic focus;

    (b) LTCs are restricted to 5 or fewer shareholders, whereas limited partnerships have no such restriction; and

    (c) LTC shareholders can, and typically will, be active in the day-to-day operation of the business, whereas limited partners are theoretically restricted to a passive role in the business.

21. Therefore, officials have proposed that the deduction limitation rule for LTCs is needed only in one specific instance. Officials have proposed retaining the deduction limitation rule for all partnerships of LTCs. They maintain that a partnership of LTCs is, in effect, a widely held investment structure, which could end up being used instead of limited partnerships. While the concern relates only to partnerships where there are more than 5 look-through owners in aggregate in the partnership, because of difficulties in requiring LTC owners to enquire about the ownership of other LTCs, the proposal is that the deduction limitation rule should apply to all partnerships of LTCs. However, submissions were invited on this point.

22. Officials are also concerned that a LTC could potentially be used for non-market transactions for tax avoidance purposes, such as "non-recourse schemes", where an investor risks only a small amount in a high risk activity, but obtains tax deductions for high-value assets that are essentially loan financed. The proposed solution is to make LTCs subject to s. GB 50, which substitutes a market value amount when a partner enters into an arrangement involving a non-market consideration and the arrangement has the purpose or effect of defeating the intent and application of the partnership tax rules. Again, submissions were invited on the feasibility of this proposal.

23. The proposal is that deductions that are limited up to the time the rule is removed would become unrestricted from the 2017-18 income year and could be offset against owners' other income from that income year.

24. For the circumstances in which the deduction limitation rule will continue to apply, officials considered whether a fundamental change to the rule was needed, and have summarised their thinking on some possible alternatives. However, they prefer retaining the existing rule with the following technical changes:

(a) A balance-sheet based starting point for the calculation of "owner's basis" for companies that enter the LTC regime, because apparently at present, it is unclear hoe the term "investments" is to be calculated;

(b) The inclusion in "owner's basis" of unrealised gains on real property calculated in a similar fashion to the mixed-use assets rules;

(c) Further consideration of the treatment of guarantees, requiring among other things, that the guarantor be a person of substances and not the LTC itself.

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