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WEEKLY COMMENT: FRIDAY 6 OCTOBER 2017

1. The *Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017* ("the Closely Held Companies Act") received the Royal assent on 30 March 2017. There are a number of changes affecting various parts of the Income Tax Act 2007 and the Goods and Services tax Act 1985.

2. This week I continue to look at the changes to the definition of a look-through company ("LTC"). In the following weeks, I will look at the other changes affecting LTCs, the qualifying companies continuity of ownership requirement, and other changes affecting closely held companies generally.

LTC definition changes 2 - 5: Changes affecting tax charities and Maori authorities

3. Officials are of the view that both charities and Maori authorities have potentially wide pools of beneficiaries and are conceptually not part of the LTC target audience. To ensure that the LTC rules are reserved for closely controlled entities, the amendments extend the trust approach of looking through to the ultimate beneficiaries to LTCs owned by tax charities (as defined in the Income Tax Act) and Maori authorities. The amendments effectively preclude direct ownership by charities and direct or indirect ownership by Māori authorities. There will be, however, some exceptions:

   (a) In order to prevent charities and Māori authorities incurring the compliance cost of converting their LTC interests to limited partnerships, another look-through vehicle that is often used to achieve the same outcome as a LTC, the amendments will not apply to "grandparented" charities and "grandparented" current Māori authorities that had interests in LTCs before the introduction of the Closely Held Companies Bill;

   (b) In addition, given that many LTC-owning trusts are likely to have charitable beneficiaries and may want to make charitable distributions, the proposed revised definition of "look-through company" will expressly allow for "no strings attached" distributions to charities that have no influence over the LTC or trust from which they receive the distribution, because such a distribution is truly a gift equivalent to a donation or is received by the charity as a residual beneficiary of the trust;

   (c) However, a trust can only make a distribution to a Maori authority beneficiary of the trust if the Maori authority is a "grandparented" Maori authority, as defined.

4. As just noted above, the new restrictions do not apply to charities and Maori authorities with existing ownership interests in LTCs that are, in effect, grandparenting structures or arrangements that were in place as at the date of the Closely Held Companies Bill's

introduction (3 May 2016). A **grandparented charity** is defined in s. YA 1 as meaning, for an entity, a charity that, before 3 May 2016:

(a) Is an owner of the entity; or

(b) Has entered into an arrangement to become an owner of the entity.

5. A **grandparented Maori authority** is defined in s. YA 1 as meaning, for an entity, a Maori authority that, before 3 May 2016:

   (a) Is an owner of the entity; or

   (b) Has entered into an arrangement to become an owner of the entity; or

   (c) Is a beneficiary of a trust that is an owner of the entity.

6. The third limb in the definition of a "grandparented Maori authority" restricts distributions from an LTC owning trust to a Maori authority that was a beneficiary of the trust before 3 May 2016 and the trust was the owner of the LTC before 3 May 2016.

7. Note, however, that the "no strings attached" exception for distributions to charities, discussed in paragraph 3(b) above, allows distributions from a trust to a charity that is not a "grandparented charity".

8. These rules are interpreted on pages 35-36 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 ("the TIB Item") as meaning that not only can charities and Maori authorities hold interests in LTCs which they had an interest in prior to 3 May 2016, but also that charities and Maori authorities can change the amount of shareholding they have in LTCs they had an interest in prior to 3 May 2016. However, they cannot acquire interests in new LTCs that they did not have an interest in before that date.

9. The following example of the grandparenting of a charity s provided on page 36 of the TIB Item:

   "Charity X is a tax charity which, on 15 April 2015, acquired a 50 percent shareholding in Widgets Ltd. On 1 April 2016 Widgets Ltd elected to become a LTC.

   On 2 May 2017, Charity X increased its shareholding in Widgets Ltd to 100 percent.

   As Charity X acquired its interest in Widgets Ltd before 3 May 2016, its interests in Widgets Ltd. are grandparented and Widgets Ltd can maintain its LTC status despite Charity X's ownership interest. The increase in shareholding by Charity X on 2 May 2017 also does not affect the LTC status of Widgets Ltd, due to the grandparenting."

10. Note that the transitional rules described in paragraphs 10 -17 of last week's <i>Weekly Comment</i> above will apply to any LTCs owned by charities, Maori authorities and trusts that cease to be LTCs as a result of a failure to meet the above requirements.

LTC definition change 6: Foreign income restrictions for LTCs with more than 50% foreign LTC holders

11. Officials are concerned that the combination of the lack of restrictions on foreign investment by LTCs and on LTCs having non-resident owners allows LTCs to be used as conduit investment vehicles, which poses reputational risks for New Zealand.

12. Amendments have been made so as to limit the foreign income of foreign-controlled LTCs, applying to income years beginning on or after 1 April 2017. This means that for taxpayers

with early balance dates, the foreign income restrictions apply for the 2018–19 income year.

13. The amendments provide that a company is ineligible to be a LTC if both:

    (a) More than 50 percent of the total ownership interest in the company is held by "foreign LTC holders" (as defined); and

    (b) The entity has foreign-sourced amounts for the income year that in total are more than $10,000 and 20 percent of the company's gross income for the year.

14. Officials have stated on page 36 of the TIB Item that the thresholds are intended to provide flexibility for some degree of combined non-resident shareholding and foreign income, and should prevent a domestic family business inadvertently falling outside the rules through an owner emigrating.

15. A **foreign LTC holder** is defined in s. YA 1 as meaning:

    (a) A non-resident; or

    (b) A trustee of a trust, if the trust has a non-resident settlor, but only to the extent of the proportion of the trust's ownership interests that is equal to the proportion of settlements, by value, made by non-resident settlors, ignoring settlements arising from services provided for less than market value.

16. It is stated on page 36 of the TIB Item that standard tests of residency will apply to determine the residency of individuals. A trust that has foreign settlors is considered to be a foreign LTC holder only to the extent of the proportion of the value of settlements made by the non-resident settlors. For example, if a trust held 50 percent of the shares in a company, and 50 percent of the value of settlements made on the trust were by non-residents, then 25 percent of the ownership interests in the company would be considered to be held by foreign LTC holders.

17. The following example is provided on page 37 of the TIB Item:

    "Company Z has two shareholders, Trust D which has a 60 percent shareholding in Company Z and Steve, who holds a 40 percent shareholding.

    Steve is an individual who is resident in New Zealand.

    Trust D is a trust which received $100,000 in cash settlements, $60,000 of the settlements were made by a non-resident settlor and $40,000 were made by a resident settlor. Therefore, 60% of the value of settlements were made by the non-resident settlor. Trust D's 60 percent shareholding in Company Z is therefore split between treated as being held by non-residents and residents on a 36:24 basis.

    Overall, 36 percent of Company Z's shares are considered to be held by foreign LTC holders and 64 percent (40 percent and 24 percent) held by residents. Because of this, the foreign income restrictions will not apply to Company Z."

18. It is noted in the TIB Item that in determining the proportion of the value of settlements made by non-resident settlors, provisions of services at below market value are not counted. These services are not counted due to the difficulty in valuing them.

Look-through counted owners changes

19. The amendments to the definition of "look-through counted owner" in s. YA 1 introduce a new limb to the definition with respect to LTCs owned by trusts to broaden the way that beneficiaries are counted, by including any beneficiary who receives any distribution from any source from the trust. All distributions to beneficiaries will be counted, irrespective of whether they are from the LTC or from other sources, or whether they are received by the beneficiary as beneficiary income, trustee income, trust capital or corpus.

20. The requirement that, in aggregate there can be no more than five look-through counted owners has not changed. Family trusts can be still be LTC-owners, providing that they meet the new rules on the extent to which the trustee(s) and beneficiaries are counted owners.

21. Under the rules up to 31 March 2017, when determining the number of look-through owners, the rules count the trustee (as a single owner) when the LTC income earned by the trust is not fully distributed to beneficiaries, as well as all beneficiaries who had received LTC income from the trust as "beneficiary income" in the current and preceding three years.

22. The revised distributions rule is to apply prospectively from 1 April 2017. It will only apply to income earned from the beginning of the 2017–18 income year. Income earned and distributed to beneficiaries or retained by the trust prior to the 2017–18 income year will be counted under the rules to 31 March 2017.

23. The revised test continues to involve looking at distributions in the current and preceding three income years. One difference under the new test is that the trustees are only counted as an owner if there are no beneficiaries who are look-through counted owners.

24. A transition rule will apply over the next four years, which involves applying both tests depending on the relevant time periods involved. For years up to 2016-17, the old test applies in relation to distributions and the way in which trustees and beneficiaries are counted as owners. For year from 2017-18 onwards, additional beneficiaries can be counted based on the new test.

25. The use of the word "persons" in the legislation is designed to ensure that there is no double counting of the same person if they received a counted distribution under the old test and also under the new test.

26. The TIB Item contains on page 33 a Table summarising the transition, as well as three examples on pages 33-34.

27. For example, for determining whether a LTC satisfies the look-through counted owners limitation in the 2017–18 income year, a person would look at distributions provided between the 2014–15 income year to the 2016–17 income year and apply the old test which looks at income sourced from a LTC interest to determine whether any beneficiaries are look-through counted owners. The person would then apply the new rule for any distributions in the 2017–18 income year to determine whether there are any additional look-through counted owners.

28. The trustee(s) will be counted as the only look-through owner:

    (a) In circumstances where no distributions have been made to any beneficiaries; and

(b) In circumstances where distributions from non-LTC income have been made to beneficiaries in years up to and including 2016-2017, but no distributions have been made to beneficiaries from 2017-18 onwards.

29. An example is provided on page 34 of the TIB Item to explain the way the transition operates, when counting look-through counted owners in the 2018-19 year:

"A LTC-owning trust has made the following distributions in the 2018-19 year and the preceding three years:

(a) 2015–16 income year**:** Distribution of LTC-sourced income to two beneficiaries;

(b) 2016–17 income year: Distribution of non-LTC sourced income to two beneficiaries;

(c) 2017–18 income year: Distribution of non-LTC sourced income to two beneficiaries; and

(d) 2018–19 income year: No distributions to date.

(e) All of the beneficiaries are separate individuals.

For the 2018–19 income year, the LTC will have four look-through counted owners. This is made up of the two beneficiaries who received distributions consisting of LTC-sourced income in the 2015–16 income year and the two beneficiaries who received (non-LTC sourced) distributions in the 2017–18 income year.

The two beneficiaries who received non-LTC sourced distributions in the 2016–17 income year are not look-through counted owners as distributions for the 2016–17 income year are counted under the old rules which do not consider distributions of non-LTC sourced income."

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