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WEEKLY COMMENT: FRIDAY 27 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 look at the qualifying companies continuity of ownership requirement, the inter-corporate dividend exemption for ex-qualifying companies, and the restriction of the "tainted" capital gains rule. Next week I will look at the remaining changes affecting closely held companies.

Qualifying companies – continuity of ownership

3. Applying from the 2017-18 and later income years, new sections HA 6(3), 6(4) and 6(5) have been inserted into the corporate requirements for a company to remain a qualifying company as follows:

   (a) First, s. HA 6(3) contains an exclusion for loss of continuity to the effect that a company is not eligible to be a qualifying company unless, at all times in an income year, a group of persons holds for the QC continuity period, minimum QC interests in the company that add up to at least 50%, where:

      (i) "Minimum QC interest", as defined in s. HA 6(5), for a person and the QC continuity period, means the lowest voting interest or market value interest they have in the company during the QC continuity period; and

      (ii) "QC continuity period", as defined in s. HA 6(5), means the period starting on the day that the Closely Held Companies Act received the Royal assent (being 30 March 2017) and ending on the last day in the income year.

   (b) Second, s. HA 6(4) sets out an exception for close relatives, being that a share transferred by a transferor to a close relative is treated as being held by a single notional person for the company from the time that the transferor acquired the share. A share subsequently transferred to a "close relative" of a subsequent transferor is similarly treated as held by the same single notional person, where, "close relative", as defined in s. YA 1 for the purpose of s. HA 6 means, for a person:

      (i) A spouse, civil union partner, or de facto partner of the person; or

      (ii) Another person who is within the second degree of relationship to the person.

4. Apart from the "close relative" exception above, it is clarified on page 45 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 ("the TIB Item") that for the purposes of the shareholder continuity measurement, changes to shareholding resulting from property relationship settlements or the death of a shareholder will be ignored when measuring a change of control. This means the rollover rule in s. FB 10 will apply for share transfers upon a settlement of relationship property and the rollover rule in s. FC 3(2) will apply when property is transferred on a person's death to the surviving spouse, civil union partner, or de facto partner of the deceased person.

Ex-qualifying companies and inter-corporate dividend exemption

5. Section CW 14 denied an exemption from income tax to a qualifying company:

   (a) That derives a dividend from another company that is within the same wholly owned group (which would otherwise be exempt under s. CW 10); or

   (b) To which the exemption in s. CW 11 for a dividend of a conduit tax relief holding company would otherwise have applied while the conduit tax relief tax regime was in force.

6. Section CW 14 did not apply, however, to the extent that a dividend is derived from a non-resident company and would be exempt from income tax under s. CW 9.

7. Effective from the 2005-06 income year onwards, s. CW 14 has been replaced so that it only applies if:

   (a) The derived dividend is derived less than 7 years after the company ceases to be a qualifying company; and

   (b) The QC paid a dividend that s. CW 15 applied to, when the company was a qualifying company – i.e. a dividend that was exempt due to being more than a fully imputed distribution.

8. A corresponding amendment to s. HA 17 means that the denial of the tax exemption in s. CW 10 for dividends derived from wholly owned group companies (other than dividends from non-resident companies that are exempt under s. CW 9) only applies while a company is a QC.

9. The corresponding provisions in the Income Tax Act 2004 have also been amended to give effect to the retrospective amendment.

10. Apparently the rule was originally introduced because there is a potential avoidance risk through a QC creating capital gains through revaluing the shares they hold in a non-qualifying company. These capital gains can be passed to shareholders as exempt dividends and funded by a loan back to the QC. If the QC then converts to an ordinary company, the company can, if the inter-corporate dividend exemption is available, receive an exempt dividend from other companies in a wholly owned group, which could be used to repay the loan from the shareholder without a tax cost.

11. However, officials have now decided that the rule extends too far and prevents the use of the wholly owned group inter-corporate dividend when the avoidance risks are minimal. Consequently, the inter-corporate dividend exemption is now available to companies that have previously been qualifying companies when either:

(a) The dividend is derived at least seven years after the company ceased to be a qualifying company; or

(b) The company never paid an un-imputed dividend while it was a qualifying company.

Restricting the scope of the "tainted capital gains" rule

12. Before the date of enactment of the Closely Held Companies Act, sections CD 44(10B) and CD 44(10C) provided that no capital gain amount was derived or capital loss amount incurred by a company after 31 March 2010 on disposing of property under an arrangement with an associated person, except if:

(a) The company is a close company (a company that is more than 50% owned by 5 or fewer natural persons); and

(b) The associated person is not a company; and

(c) The disposal is on the liquidation of the company.

13. Effective from 30 March 2017, the date of enactment of the Closely Held Companies Act, sections CD 44(10B) and CD 44(10C) have been replaced by new sections CD 44(10B) to CD 44(10E) as follows.

14. New s. CD 44(10B) sets out the new rule that determines whether a capital gain amount or a capital loss amount will be "tainted" – i.e. there will be no capital gain or loss in the circumstances set out in s. CD 44(10B).

15. An amount derived or incurred by a company upon disposing of property to another company is not a capital gain amount or a capital loss amount if:

(a) At the time of disposal a group of persons hold at least 85% of the common voting interests (and, if a market value circumstance exists for either company, common market value interests); and

(b) Upon the liquidation of the company that disposed of the property the aggregate total given by applying the following formula in s. CD 44(10C) for all "owning companies" that own part of the property, is 85% or more:

commonality interest × ownership interest.

16. In this formula:

(a) "Commonality interest" is:

(i) If the owning company is the company that disposed of the property, 100%; or

(ii) If the owning company is another company, the percentage of common voting interests between that company and the company that disposed of the property (or, if a market value circumstance exists for either company, the percentage of common market value interests between that company and the company that disposed of the property, if greater than the common voting interests); and

(b) "Ownership interest" is the percentage ownership of the property, by market value, for the owning company.

17. This rule is overridden by the rule in s. CD 44(7)(c) that a company derives a capital gain amount from another company upon liquidation of the other company if the distribution is excluded from being a dividend under s. CD 44.

18. The new rule works based on the extent to which the property disposed of continues to be owned at least 85% by persons associated with the seller. The capital gain or capital loss will be ”tainted” if:

    (a) The company that disposed of the property owns the property (i.e. re-acquired it in some way); or

    (b) For all other companies that have a share in the ownership of the property and also have a commonality of shareholding with the company that disposed of the property, the sum of the amounts calculated as: (ownership interests x commonality of shareholding) is at least 85%.

19. It is noted on pages 47-48 of the TIB Item that:

    (a) Where an asset of a company is sold to another company in the same wholly owned group for a capital gain and at a later stage is on-sold to a non-associated company for a further capital gain, with both companies being liquidated, both gains will be non-taxable as the outcome of the series of transactions is that by the time of the liquidation distribution the asset has been sold to a company that has no common ownership with either company in the wholly owned group;

    (b) If the owner at the time of liquidation is a non-corporate, there will be no “owning companies” , therefore, the gain or loss will not be tainted;

    (c) If an asset ceases to exist on the liquidation, any capital gains or losses from the asset will not be tainted. This is because, at the time, no company owns the asset.

20. The new rules apply to liquidations of a company from the date of enactment, which means the new formula applies to capital gain or loss amounts that were made prior to the date of enactment (including gains to which the “related persons” test previously applied) as long as the liquidation occurs after the date of enactment.

21. The threshold is set at 85 percent because a change of ownership to an unrelated third party of more than 15 percent provides sufficient assurance that the transaction is genuine and involves a real transfer of the underlying assets rather than being in lieu of a dividend.

22. The following examples are provided on page 48 of the TIB Item.

23. Beach Resort Ltd and Ice Cream Deluxe Ltd are associates with a common shareholder holding 60% of the voting interests in each company. The remaining 40% of shareholdings in each company are held by different persons:

    (a) On 1 May 2005, Ice Cream Deluxe Ltd sold its ice cream cart to Beach Resort Ltd with Ice Cream Deluxe Ltd making a capital gain of $10,000 on the transaction.

    (b) On 1 September 2018, Ice Cream Deluxe Ltd is liquidated. The $10,000 capital gain is not tainted as no group of persons hold common voting interests of 85% or more in both companies.

24. Company A acquires a boat for $400,000. Company A sells the boat to Company B for $500,000. Company A and Company B have common voting interests of 90%:

(a) The boat sinks and Company B has to write off the asset as it is neither salvageable nor insured. Company A and Company B subsequently liquidate.

(b) The $100,000 capital gain for Company A and the $500,000 capital loss for Company B will not be tainted. This is because on the liquidation, neither Company A nor Company B own the asset and the ownership interest for the asset is 0% as no one owns it.

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