KPMG

TaxMail

10 September 2015

Regular commentary from our experts on topical tax issues

Issue 4

Close company tax changes

Snapshot

An Officials' Issues Paper suggests changes to the current tax rules for close-companies (i.e. companies with five or fewer shareholders), including:

- The removal of restrictions on expense deductibility under the Look Through Company ("LTC") tax rules. However, the entry requirements to become a LTC will be strengthened.
- Removing the "tainting" of capital gains made with associates and the need to deduct withholding tax on dividends paid to shareholders in a number of circumstances.

The changes are the result of a broad review of the close-company tax rules by Inland Revenue Officials and are generally taxpayer friendly. However, not all of the changes are positive. For example, there will be additional restrictions on trust shareholders in LTCs, while existing qualifying companies would lose this tax status on change of ownership.

This is an important document for New Zealand's many privately owned businesses. The 68 pages will repay close review. Submissions are due by 16 October.

The Issues Paper is an important document for New Zealand's many privately owned businesses

Its implementation should allow them to make informed choices with clear outcomes. The document will repay close review

The disappointment is that many of the issues have been around since the 2010 introduction of the LTC rules

Contact us

John Cantin
Partner, Tax
T: +64 4 816 4518
E: jfcantin@kpmg.co.nz

Darshana Elwela
National Tax Director
T: +64 9 367 5940
E: delwela@kpmg.co.nz

What is being proposed?

Officials have reviewed the current LTC, qualifying company and other close-company tax rules. The proposed changes are as follows:

LTC entry requirements

For trust shareholdings in a LTC:

- A beneficiary that has received any distribution in the last six years from the trust shareholder will now be a "counted owner". The trustee will continue to be a single counted owner if there are no such distributions.
- Distributions by a trust shareholder to a company, which is not itself an LTC, will mean the LTC will no longer be eligible to be a LTC.

Charities and Māori authorities will be prevented from being shareholders in LTCs or beneficiaries of trusts that own shares in LTCs. Charities will however be able to receive up to 10% of the LTC's income as beneficiary income.

A LTC will be allowed to have more than one class of share (e.g. to provide for different voting rights), provided all shares still have uniform entitlements to income and deductions.

A LTC's foreign income will be restricted to the greater of $10,000 or 20 percent of its gross income when more than 50 percent of the LTC's shares are held by non-residents.

LTC entry tax calculation

On entry to the LTC regime, a company pays tax at 28% on retained earnings which are not covered by imputation credits. This means there is no additional tax for shareholders on the 33% tax rate. The entry tax calculation will be changed so that it reflects shareholders' marginal tax rates, rather than the company rate of 28%.

Qualifying companies that transition to a LTC would also be subject to this rule and would forfeit any losses carried forward.

Deduction limitation rule

The deduction limitation rule (which is intended to limit deductions for expenses to the amount invested in the company – i.e. capital at risk) will be removed for LTCs. The exception is where there is a partnership of LTCs.

Deductions carried forward under the present deduction limitation rule will be able to be fully used in the 2017-18 income year.

Current anti-avoidance rules for partnerships, designed to ensure transactions between the partnership and partners occur at market value (if there is an arrangement to defeat the partnership rules), will be extended to LTCs.

Debt remission

There will be no debt remission income to a shareholder when they remit an amount owed to them by the LTC. (This is consistent with the Government's recent related-party debt remission and debt capitalisation proposals, discussed here.)

However, the debt remission rules will apply as intended, for third-party debt, where the company is liquidated or the owners revoke LTC status. This will have retrospective effect for historic liquidations and LTC status revocations.

Qualifying companies

Qualifying companies will remain part of the close-company tax rules. However, a company's qualifying company status, and the associated tax benefits, will be lost if there is a sale of the company.

Contact us

John Cantin
Partner, Tax
T: +64 4 816 4518
E: jfcantin@kpmg.co.nz

Darshana Elwela
National Tax Director
T: +64 9 367 5940
E: delwela@kpmg.co.nz

"Tainted" capital gains

Capital gains generated by a sale of property by a close-company to a non-corporate associate will generally no longer be "tainted". (Tainted capital gains are taxable on distribution, including on liquidation of the company.)

Close-company dividends and interest

The deduction of resident withholding tax ("RWT") from fully imputed dividends between companies would be made optional.

Further work will be done as part of Inland Revenue's "Business Transformation" on removing RWT obligations for small companies for dividends and interest they pay to their shareholders.

RWT obligations when cash and non-cash dividends are paid concurrently will be streamlined, so that they can be treated as a single dividend.

Shareholder salaries

Close-companies will be able to choose whether shareholder salaries should be subject to a combination of PAYE and provisional tax. The company will need to maintain a consistent approach from year to year.

Who should take note, and why?

The Issues Paper proposals are aimed at limiting the LTC (and other close-company) tax rules to mainly small family-owned companies. New Zealand's many privately owned businesses should take note. This means, for example, that trust shareholdings are being restricted because of a perceived concern that they could be used to mask widely-held investors. Simplifying the rules, such as removing RWT on close-company dividends and interest and the tainting of related-party capital gains, are also with this objective in mind.

Officials have based their conclusions on the statistical analysis in Appendix 1 of the Issues Paper. This shows the take-up of the LTC (and qualifying company) rules and the distribution of taxable income (and losses) of these companies. In 2013, there were approximately 46,000 LTCs and almost 69,000 qualifying companies with 80 percent of LTCs in the loss/income range -$30,000 to +$10,000 while 80 percent of qualifying companies were within the -$20,000 to +$20,000 range.

The relatively low levels of income (and losses) to date explains why relaxing the rules limiting deductions, for example, has Officials' support. The potential revenue risk is expected to be within generally acceptable tolerances.

Our view

A review of the close-company tax rules has been on the Government's tax policy work-programme since their 2010 introduction. The rushed introduction of that legislation has meant there have been significant remedial measures. The Issues Paper suggests further changes.

Overall, a number of the proposals are taxpayer friendly. In our view, these should have been part of the 2010 LTC package. We welcome the relaxation of the deduction limitation rule in particular. The practical operation of this rule has been a source of frustration for taxpayers and their advisers. Similarly, proposals to simplify the RWT rules for close-company dividends and interest are welcome.

The removal of some "tainted" capital gains for close-companies recognises that there will be genuine commercial transactions between close-companies and their associates which should not be taxed. This is strongly supported. However, the review does not satisfactorily address the requirement that, otherwise, capital gains can only be distributed tax-free on liquidation. This rule limits restructurings and is inefficient. This important issue remains outstanding.

Contact us

John Cantin
Partner, Tax
T: +64 4 816 4518
E: jfcantin@kpmg.co.nz

Darshana Elwela
National Tax Director
T: +64 9 367 5940
E: delwela@kpmg.co.nz

There is a dark cloud to every silver lining. In the case of the LTC regime, this is mainly around changes to the entry requirements. While we recognise Officials' concerns to target the LTC regime appropriately, the proposal to treat beneficiaries as counted owners for a six year period seems excessive.

The proposed loss of qualifying company status on sale of a company will also need to be carefully managed by existing shareholders.

There are two proposals which affect changes to and from LTC status.

The rule to tax untaxed retained earnings at 33%, on entry in the LTC rules, is understandable from a policy perspective. We note however that the current policy has caused problems as it has created uncertainty regarding the ability to use the LTC regime. (See our 2014 taxmails on the Commissioner's QWBA on tax avoidance, which concluded that winding up a company post conversion to LTC status was tax avoidance. This change will "fix" that view as the LTC election will not create a tax benefit.)

The other is a proposed retrospective change to confirm the effect of revoking LTC elections on third party debt. On revocation of LTC status, there is a deemed disposal of the debt for market value. Officials are concerned that some LTC shareholders argue that the face value of the loan is the market value, if the company cannot repay the debt. This means there is no debt remission income to the shareholder on a look-through basis. The debt remission income arises later. The insolvent company then has the tax liability.

The ordinary meaning of "market value" would take into account the effect of impairments. However, the Act changes this result for a lender who is not in the business of making loans. The Act prevents a lender from claiming a deduction. It appears that Officials' concern is borrowers are also using this rule and it will be amended to prevent them from doing so.

This proposal highlights, once more, the unevenness and unfairness of the debt remission rules. A loss is not deductible but a gain is taxable. Officials' debt capitalisation technical analysis justifies the taxation of the gain on the basis that it "increases the wealth of the debtor". Ignoring the point that this is in effect an argument for a capital gains tax, it could equally be said that the loss "decreases the wealth of the debtor" and that the loss should be deductible.

Finally, the document has an extensive discussion on the reasons why foreign income and shareholdings of an LTC should be restricted. These include concerns around New Zealand being used as a conduit to generate tax-free income and to prevent foreign tax credits being used.

The conduit concerns appear overstated. New Zealand has committed to providing other countries information on New Zealand companies controlled by their tax residents. This transparency should limit the ability of non-residents to use LTCs to hide income from their own country. The concern that LTCs allow the benefit of foreign tax credits to be passed through, when this is not available to normal companies, raises some fundamental questions regarding double taxation and the benefit to New Zealand of investing offshore. It is understandable that the Issues Paper does not consider it. However, it does and should be kept under review.

At 68 pages, the Issues Paper is one of the longer consultation document released this year. There is significant technical detail that warrants further attention. At the risk of repetition, the devil will be in that detail.

For further information

John Cantin
Partner, Tax
Wellington
Phone: +64 4 816 4518
Email: jfcantin@kpmg.co.nz

Darshana Elwela
National Tax Director
Auckland
Phone: +64 9 367 5940
Email: delwela@kpmg.co.nz