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Closely held company taxation issues
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Closely held company taxation issues – officials' issues paper

Introduction

1. The Law Society welcomes the opportunity to comment on the IRD officials' issues paper *Closely held company taxation issues* (Issues Paper).

2. The Issues Paper proposes a number of changes to the look-through companies (LTC) regime and related changes to the grandfathered qualifying companies (QC) regime in order to reduce compliance costs for LTCs and to reduce perceived opportunities for avoidance.

Preliminary comments

General points

3. The proposals in the Issues Paper are intended to address two broad concerns relating to LTCs:

   - concern that taxpayers are choosing not to use LTC structures because of the complexity of the regime; and
   - concern that the present rules potentially allow the use of LTC structure beyond the very narrow class of small-scale commercial ventures for which it (and indeed the QC regime on which it is based) was designed.

Concern about the complexity of LTC structures

4. The Law Society, while appreciating any effort to simplify taxation legislation, is concerned that the Issues Paper proposes to resolve perceived complexity by creating more rules and exceptions to the LTC regime. These rules and exceptions would, if adopted, broadly:

   - further refine the qualifying criteria for LTC status; and
   - abolish the loss-limitation rule applicable to LTCs except in very limited circumstances.

Adding more rules about the identity of shareholders and beneficiaries of shareholders and doubling the period during which beneficiaries who receive distributions from trusts can be counted as look-through increases the risk that an LTC could inadvertently cease to qualify for LTC status. Being aware of the significant risk but not fully understanding the complex rules could well lead fewer people to choose an LTC structure.

5. Further, the Law Society submits that applying the loss limitation rule in some circumstances and not in others would undermine commercial certainty. This would be exacerbated by the proposal to expand section GB 50 of the Income Tax Act 2007 (the Act) to apply to LTCs, as anti-avoidance provisions are inherently uncertain in scope and effect.

Further restricting the use of the LTC structure

6. The Law Society agrees that the proposed changes are consistent with the general design of the QC regime on which the LTC regime is based, however it is difficult to see the policy justification for altering the LTC regime to more closely resemble the regime it replaced. Taxpayers who wish to: operate conduits for overseas income; include ordinary limited companies or charitable trusts among their beneficiaries; or simply distribute to a wide beneficiary class, are able to achieve all the benefits of an LTC (limited liability, effective separate legal personality, tax transparency within limits) using a limited partnership. It seems likely, therefore, that tightening the LTC regime will simply increase the preference of taxpayers for limited partnerships and decrease the use of LTCs as commercial structures, with no net tax effect.

7. Accordingly, the Law Society respectfully submits that the proposals set out in the Issues Paper — while generally correct in principle — are unnecessary, and may even be harmful, in practice. However, some specific comments in relation to certain proposals follow, in the event that they are to be further considered.

Comments on specific proposals

Entry criteria – general comment

8. As noted above, the policy justification for restricting the eligibility criteria for entry to the LTC regime to more closely resemble those of the QC regime is unclear. It would be more helpful to consider the LTC regime as a standalone regime without reference to the regime that it was intended to replace.

Entry criteria – counting beneficiaries and trustee income

9. The Issues Paper proposes to extend the definition of "look-through counted owners" so that beneficiaries who have received distributions from the trust during the preceding six years are counted. This is a doubling of the current three-year period and targets a perceived concern that the current three-year period is too short and might allow for the "rotation" of benefits to beneficiaries without impacting upon eligibility for LTC status. The Law Society does not in principle oppose this change. However, it is not clear that it would address any problem of beneficiary rotation. Rather, it would simply extend the time-frame in which any such rotation could occur and add to the complexity involved in the

administration of an LTC as well as the possibility that an LTC could inadvertently cease to qualify as an LTC.

10. Moreover, it does not (and cannot) limit the ability of family trusts holding shares in an LTC to make a distribution to one family member (the counted owner) for the benefit of another in certain circumstances.

11. The Issues Paper also proposes to count as "look-through counted owners" not only trust beneficiaries who have received distributions of beneficiary income but also beneficiaries who have received distributions of trustee income. The Law Society respectfully disagrees with this proposal. Where shares in an LTC form part of a trust fund, it is the trustees who are the legal owners of the shares and, where any income derived from them is treated as trustee income, taxed upon it. Counting beneficiaries who receive distributions of trustee income as look through counted owners is analogous to counting a person who receives a gift of money from another person who holds shares in an LTC as a shareholder of the LTC in the recipient's own right. There is no harm, as the money constituting the gift (distribution) has already been subject to tax. Further, as the trustee rate and the top marginal income tax rate are aligned, there is no tax advantage to be gained from electing to receive income from a trust as trustee income rather than as beneficiary income.

Entry criteria — excluding corporate and charitable beneficiaries

12. The proposed rules prohibiting trusts that hold shares in LTCs from distributing to corporate beneficiaries are problematic. First, there are legitimate commercial reasons why it might be desirable for a trust to include corporate beneficiaries amongst its beneficiaries and second, it is unclear whether a trust that has once distributed to a corporate beneficiary is (or indeed should be) permanently banned from being a shareholder in an LTC. In this regard, it seems inconsistent to count natural person beneficiaries for only three years or six years, but to ban permanently a trust that has once distributed to a corporate beneficiary. Further, if the concern is income sheltering, there seems to be no justification for prohibiting distributions of trustee income to a corporate beneficiary. As mentioned above, trustee income has already been subject to tax at 33%, and accordingly there is a 5% disadvantage if a corporate beneficiary (subject to tax at 28%) receives a distribution of trustee income.

13. It also seems inconsistent that trusts should be permitted to have corporate beneficiaries but not distribute to them while not permitting charities to be beneficiaries of a trust that holds shares in a look-through company, whether or not any distributions are made to those beneficiaries. This could have significant ramifications as many (if not most) New Zealand family trusts allow distributions to charitable organisations. Indeed, there are probably many more family trusts including charities than companies among their beneficiaries. It also appears to be counter to the general policy of encouraging charitable donations (as evinced by the donee tax credit provisions in the Act).

14. Apparently recognising this, the Issues Paper proposes that a trust that holds shares in a look-through company could still be permitted to donate 10% of its net income to charitable entities without giving rise to a loss of look-through company status. However, this creates a fundamental problem: trustees can only apply trust funds for the benefit of beneficiaries. If

a trust is not permitted to include charities amongst its beneficiaries, it is, with extremely limited exceptions, not permitted to apply its funds to charities. Accordingly, having a safe-harbour rule for donations by trusts to charities below a certain level is rendered meaningless.

15. As an alternative, the Law Society proposes that beneficiaries of a trust that holds shares in a look-through company could include non-natural persons such as companies or charities provided that:

- in the case of companies, no distributions of trustee income are made to those companies from the beginning of the 2017/2018 income year; and
- in the case of charities, distributions to charities from a trust that owns shares in an LTC do not exceed 10% of the net income received by the trust from its look-through interests in any income year.

Look-through companies and shareholder salaries (dividend simplification)

16. The Issues Paper proposes to amend section RD 3 of the Act so that a "close company" (as defined) will be able to pay both a PAYE-deducted salary and shareholder salary to a shareholder-employee of a "close company". The Law Society submits that this proposal does not go far enough in that it does not enable a shareholder salary to be paid to a "working owner" of a look-through company. Currently, the inability to pay a shareholder salary to a "working owner" of a look-through company causes problems where the amount to be paid to the "working owner" turns on the profitability of the business carried on by the look-through company, which will not be known until the financial accounts are prepared after year-end.

17. Under the PAYE rules, it is possible to pay a salary to a shareholder-employee of a close company without deducting PAYE where certain criteria are satisfied (section RD 3(2) of the Act). Although a look-through company is a company for the purposes of the PAYE rules, it is not possible to pay a shareholder salary with no PAYE deducted to a “working owner” of a look-through company. Section RD 3(2) provides that a salary may be paid to a shareholder-employee of a “close company” with no PAYE deducted. A look-through company is a company for the purposes of the PAYE rules, but is not a company for the purpose of the definition of “close company” in section YA 1 (that definition is not part of the PAYE rules). As such, section RD 3(2) cannot apply to allow a look-through company to pay a salary to a “working owner” without PAYE deducted and the proposed reforms do not change this.

18. While in practical terms this issue could be addressed by completing the look-through company accounts and making an additional bonus payment within 63 days of the look-through company’s balance date, this will not be possible in many instances. As such, the Law Society suggests amending paragraph (abb) of the definition of “company” in section YA 1 of the Act to provide that "company" includes a look-through company in the definition of “close company” for the purposes of the PAYE rules.

Existing Qualifying Companies

19. The Law Society recommends that the remnants of the QC regime be repealed and replaced by a special set of rules that would apply to distributions made by a "close company".

20. These new dividend rules would provide, inter alia, that non-cash distributions made by close companies would not be subject to income tax and that cash distributions made by close companies would be subject to income tax only to the extent that that distribution is able to be fully imputed (i.e. much the same rules that currently apply to qualifying companies). The definition of "close company" would need to be amended so that it did not exclude companies where 50% or more of the shares are held by one or more family trusts. Perhaps "close company" could be defined by reference to the five or fewer "look-through company counted owner" test that currently applies to LTCs.

21. There should also be a grand-parenting provision to the effect that any company that was a QC immediately prior to the repeal of the qualifying company regime would be treated as a "close company". Under this proposal, it may not be necessary to amend (or repeal) the so-called "associated person capital gains" rules, as such gains could be distributed tax-free in any event.

Associated persons capital gains

22. The Law Society submits that the proposals in the Issues Paper in relation to associated person capital gains do not go far enough. The Law Society is concerned that the proposals may have arisen from a lack of consideration of why the associated person capital gains provisions were originally inserted.

23. The Law Society understands that the associated person capital gains provisions were inserted in the early 1980s to prevent large corporates from "creating" a capital gain that could be distributed tax-free to shareholders. This was at a time that dividends were either treated as "income dividends" or "capital dividends", with only the former being subject to income tax in the shareholders' hands. It was also prior to the implementation of the imputation credit regime, which "softened" the classical approach to taxing distributions from companies.

24. Arguably, such a rule is no longer necessary as all dividends paid during the continuance of a company are now subject to income tax, irrespective of the source of that dividend. Further, the change in the associated person capital gains rules in 2009, which prevented such gains from being able to be distributed tax-free on liquidation where those gains arose from a transaction with an "associated person" (under the wider definition of associated persons) rather than "related persons" (which was defined somewhat narrowly), expanded the circumstances in which "tainted" capital gains arise, and prevents taxpayers from structuring genuine commercial transactions in a manner that would not give rise to such a "tainted" capital gain.

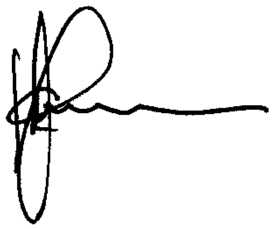
25. Accordingly, the Law Society submits that the restriction on distributing "associated person capital gains" tax-free on liquidation should be repealed, with application to distributions made on or after the date of enactment.

26. Alternatively, the restriction could be repealed for “close companies” (which term would need to be redefined as discussed above). This would be consistent with the statement made in paragraph 2.15 of the Issues Paper that “Individual treatment should be applied to company situations when the investment could have genuinely been owned directly by the individual or family trust shareholder(s) but they wish to have the protection of limited liability”. A further alternative could be to extend the relaxation of the “associated person capital gains” rule to situations where the associated person is a company, at least where the company generating the capital gain is a “close company” (as redefined above).

Conclusion

27. This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further, please do not hesitate to contact the committee's convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967/ jo.holland@lawsociety.org.nz).

Yours faithfully



Chris Moore
President