



WEEKLY COMMENT: WEDNESDAY 25 JULY 2012

1. The New Zealand tax treatment of US LLCs is something that has always interested me. This week and next week, I consider, in two parts:
 - The New Zealand tax treatment of LLCs in general and the historical introduction of the grey list exemption and CFC tax credits for LLCs and the treatment of dividends (Part 1).
 - The foreign tax credit implications of investments in US LLCs and the expansion of the CFC same country exemption so that it applies US LLCs (Part 2).

New Zealand tax treatment of US LLCs: Part 1

2. I obtained this summary about US LLCs from the [OCRA website](#):

“In the United States an LLC is not a partnership or a corporation. It is a distinct business entity that offers an alternative to partnerships and corporations by combining the corporate advantages of limited liability with the partnership advantage of pass-through taxation. In general, US LLCs with non-resident members and which conduct no business in the US and which have no US-source income are not subject to US federal income tax and are not required to file a US income tax return. US LLCs are popular vehicles for conducting international business.”

3. A US LLC is a company for New Zealand tax purposes. This has been confirmed by recent tax amendments and by the relevant definitions in section YA 1 of the *Income Tax Act 2007*.

Recent income tax amendments

4. A series of income tax amendments in recent years has confirmed that a US LLC is a company, and an interest in a US LLC is an interest in a CFC or a FIF for New Zealand tax purposes:
 - The *Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006* which:
 - (a) Amended the definition of “grey list company” so as to include US LLCs; and
 - (b) Amended the CFC tax credit rules to take account of the US look-through tax treatment afforded US LLCs; and
 - (c) Amended the dividend rules to take account of tax paid by a shareholder in a US LLC.

- The *Taxation (International Investment and Remedial Matters) Act 2012* which:
 - (a) Expanded the CFC same country income exemption so that it can apply to CFCs that are US LLCs; and
 - (b) Abolished the grey list exemption for FIF direct income interests of 10% or more, from income years beginning on or after 1 July 2011, which means that interests of 10% or more in a US LLC that is not a CFC will be subject to the FIF tax regime.

Section YA 1 definitions

5. In New Zealand, a US LLC falls within the opening paragraph of the definition of **company** in section YA 1 of the *Income Tax Act 2007*, which:
 - Means a body corporate or other entity that has a legal existence separate from that of its members, whether it is incorporated or created in New Zealand or elsewhere:
 - Does not include a partnership:
 - Does not include a look-through company...
 - Includes a listed limited partnership:
 - Includes a foreign corporate limited partnership:
 - Includes (other specific inclusions).(emphasis added)
6. The definition of “company” excludes a partnership, but includes a “foreign corporate limited partnership”. Upon the introduction of the Limited Partnership Tax Regime in 2008, there was a question in my mind as to whether a US LLC could be regarded as a partnership or a limited partnership for New Zealand tax purposes. However, that is not the case, because a US LLC, if it is a “partnership”, fits the definition of a **foreign corporate limited partnership** in section YA 1 of the *Income Tax Act 2007*:

“**foreign corporate limited partnership** means an entity or group of persons that—

 - (a) Meets the definition of **overseas limited partnership** in section 4 of the *Limited Partnerships Act 2008*; and
 - (b) Is treated as a separate legal entity under the laws (other than taxation laws) of the country, territory, or jurisdiction where it is established.”
7. An **overseas limited partnership** in section 4 of the *Limited Partnerships Act 2008* means:

“A partnership formed or incorporated outside New Zealand with—

 - (a) 1 or more general partners who are liable for all of the debts and liabilities of the partnership; and
 - (b) 1 or more limited partners who have only limited liability for the debts and liabilities of the partnership.”
8. It may be possible to structure a US LLC so as to fall within the ambit of the definition of an “overseas limited partnership”. (However, the relation between members of a company is not a “partnership” within the meaning of section 4(1) of the *Partnership Act 1908*.) In any case, a US LLC falls within paragraph (b) of the definition of **foreign corporate limited**

partnership, because it is treated as a separate legal entity under the laws (other than taxation laws) of the US.

A US LLC must be tax resident in New Zealand to be a look-through company

9. The exclusion for a look-through company cannot apply unless a US LLC:
 - (a) Is resident in New Zealand under section YD 2; and
 - (b) Is not treated as not resident in New Zealand under a double tax agreement.
10. If a US LLC is regarded as also resident in New Zealand, under paragraph 4 of Article 4 of the Double Tax Agreement with the US the competent authorities of the US and New Zealand must endeavor to settle the question by mutual agreement, or the LLC will not be treated as a resident of either the US or New Zealand for treaty purposes.

Treatment of US LLCs under the grey list exemptions

11. In 2006 amendments were introduced to allow people who invest in foreign hybrids to receive grey list treatment and foreign tax credits for tax they pay overseas on income earned by a foreign hybrid. As part of those amendments, the definition of **grey list company** in section YA 1 was amended, so as to include as paragraph (b) of the definition, a company that is resident in a grey list country if:

“The company is organised under the laws of the country and the country—

- (a) Imposes on persons holding income interests in the company the liability for income tax on the company's income; and
- (b) Under the laws of the country, is the source of 80% or more of the income of the company.”

12. This effectively included a US LLC as a grey list company. This was done for the purposes of the grey list exemption, which existed at that time. The *IRD's website* explanation of the rule change to permit the grey list exemption for hybrid entities, such as LLCs was as follows:

“The law has been clarified to allow people who invest in "foreign hybrids" to receive "grey list" treatment and foreign tax credits for tax they pay overseas on income earned by a foreign hybrid. The changes apply to foreign hybrids that are either a controlled foreign company (CFC) or a branch-equivalent foreign investment fund (FIF).

A foreign hybrid is an entity that has the characteristics of both a company and a partnership. It is treated as a company for New Zealand tax purposes, but is treated like a partnership (with "flow-through" tax treatment) or a branch of the parent company under another country's tax system....

Under New Zealand domestic tax legislation, *an interest in a foreign hybrid entity which has a separate legal personality is treated as an interest in a "company" and taxed as such*. An investment by a New Zealand resident in a foreign company will usually be treated as an investment in a CFC or a FIF. An investor in a CFC (or FIF) can usually claim a foreign tax credit for tax paid on its foreign income.

The Income Tax Act 2004 has been amended as follows:

- Sections EX 24 and EX 33 (of the Income Tax Act 2004) enable taxpayers to receive a grey list exemption from the CFC and FIF rules for investments in foreign hybrids....

- Section CD 10C (of the Income Tax Act 2004 – now section CD 18 of the Income Tax Act 2007) allows the amount of a dividend received from a foreign hybrid to be reduced by the amount of foreign tax paid by the New Zealand shareholder on income earned by the hybrid.”

(emphasis added)

13. The grey list exemption for CFCs was removed in 2009. The definition of “grey list company” is no longer relevant for the purposes of the CFC rules. However, it remains relevant for the purposes of the FIF rules. The exemptions in sections EX 35, EX 36, EX 37, EX 37B, EX 38 and EX 39 all refer to “grey list company”.
14. The exemption in section EX 35, for direct income interests of 10% or more in a FIF that is a grey list company, continues to apply for income years beginning on or before 30 June 2011. A direct income interest of 10% or more in a US LLC in which a person has an income interest of 10% or more and that is not a CFC will be exempt under this exemption. This exemption will not apply for income years beginning on or after 1 July 2011.
15. The venture capital exemptions in sections EX 36, EX 37 and EX 37B apply if the FIF is a grey list company. So does the exemption in section EX 38 for an employee share purchase scheme of a FIF that is a grey list company.

Treatment of “dividends” from LLCs

16. In recognition of the fact that US LLCs (and other similar foreign companies) do not themselves pay tax on income distributed to their members, section CD 18 provides that the amount of a “dividend” that is taxable in New Zealand is reduced by the foreign tax paid by a person who:
 - (a) Derives a dividend from a foreign company; and
 - (b) Has a liability to tax on the foreign company’s income, under the laws of a foreign country, corresponding to the tax liability the person would have under New Zealand laws if the foreign company were a partnership and the person was a partner; and
 - (c) Pays the income tax; and
 - (d) Provides information, upon request, to the Commissioner to verify the tax paid.
17. If the New Zealand shareholder in a US LLC is a company, regardless of whether the LLC is a CFC or a FIF, the dividends are tax-exempt under section CW 9, unless they are paid in relation to rights that are fixed-rate foreign equity or rights to a deductible foreign equity distribution. These exceptions can give rise to problems.
18. Under the amended definition of “deductible foreign equity distribution” in section 132(16) of the *Taxation (International Investment and Remedial Matters) Act 2012* the exception would apply, and the dividend would be taxable if, for example, a US LLC derives a deductible distribution from another US company that is distributed to a New Zealand shareholder. If the US LLC does not have an active income exemption, the income from the deductible distribution would also be directly taxable as attributed CFC income. Due to the abolition of BETAs, there is no offset available which allows the tax on the attributed CFC income to be offset against the tax on the dividend income.
19. In addition, the New Zealand shareholder’s share of the LLC’s interest income will be directly taxed in the US (essentially as a partner’s share). The interaction between section

LK 1, which allows a tax credit against attributed CFC income, and section CD 18, which allows a dividend to be reduced by tax paid, is unclear.

20. If the New Zealand shareholder in a US LLC is not a company, and the LLC is a CFC, dividends from the CFC are taxable, but BETA accounts can be used to offset tax paid on attributed CFC income against any tax payable on the dividend. If the LLC enjoys an active income exemption, section CD 18 will reduce the taxable amount of a dividend by any tax paid by the shareholder in the US.
21. If the New Zealand shareholder in a US LLC is not a company, and the LLC is a FIF, dividends from the LLC would be tax-exempt under sections EX 59 and CD 36 if the shareholder uses the CV, Cost or DRR methods. If the FDR method is used for income years beginning on or before 30 June 2011, dividends are exempt unless the LLC shareholding was 10% or more at the beginning of the year, and fell to less than 10% during the year. In that particular case, dividends are taxable in that year. Otherwise, dividends are exempt when the FDR method is used.
22. If the New Zealand shareholder in a US LLC is not a company, and the LLC is a FIF, dividends from the LLC will be taxable if the shareholder uses the Attributable FIF Income (AFI) method in income years beginning on or after 1 July 2011 for the interest in the LLC. Section CD 18 will apply to reduce the amount of the taxable dividend by the shareholder's share of the LLC's tax in the US.



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