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CLOSE COMPANIES AND PARTNERSHIPS

CONTENTS **Paragraph Nos.**

1. Tax rates 1 - 4

2. Changes to the qualifying company tax regime: 5 - 14

- 2.1 QC regime closed off and LAQC regime repealed 5 - 8
- 2.2 Flat-owning companies 9
- 2.3 Restrictions on amalgamations 10
- 2.4 Continuity of ownership requirement 11 - 12
- 2.5 Allowing the intercorporate dividend exemption for ex-QCs 13 - 14

3. Key aspects of the look-through company tax regime: 15 - 112

- 3.1 Definition of “look-through company” 16 - 28
- 3.2 Look-through counted owners 29 - 34
- 3.3 Losing LTC status due to 1 April 2017 changes: transitional rule 35 - 40
- 3.4 LTC entry tax changes 41 - 52
- 3.5 Deduction limitation rule 53 - 61
- 3.6 Self-remission of LTC debts 62 - 73
- 3.7 Taxation of debts forgiven by third parties 74 - 80
- 3.8 LTCs distinguished from owners: LTC Elections 81
- 3.9 LTCs distinguished from owners: LTCs and financial arrangements 82 - 83
- 3.10 LTCs distinguished from owners: CFC and FIF interests 84 - 87
- 3.11 GST grouping 88
- 3.12 Payments to a working owner 89 - 92
- 3.13 Treatment of disposals and safe harbour rules 93 - 94
- 3.14 Tax filing obligation and tax disputes process 95 - 98

- 3.15 Deduction of an owner's interest expenditure 99 - 100
- 3.16 LTC income and deductions 101 - 104
- 3.17 Distributions from an LTC 105 - 107
- 3.18 Valuation of an owner's investment in an LTC 108 - 110
- 3.19 FIF Income 111
- 3.20 Deduction of losses carried forward from a QC 112

4. Qualifying companies compared to look-through companies: key points 113 – 150

- 4.1 Ownership requirements 114 - 121
- 4.2 Income and deductions 122 - 123
- 4.3 Tax rate 124 - 125
- 4.4 Loss attribution 126 - 127
- 4.5 Debt remission rules 128 - 130
- 4.6 QC and LTC interest deductions 131 - 134
- 4.7 Shareholder interest deductions 135 - 136
- 4.8 Payments to shareholder-employees 137 - 144
- 4.9 Attribution of income to a working person 145 - 146
- 4.10 Dividends and capital reductions 147 - 148
- 4.11 Losing status 149 - 150

5. Qualifying companies compared to partnerships: key points 151 – 163

- 5.1 Ownership requirements 152 - 154
- 5.2 Income and deductions 155
- 5.3 Partnership interest deductions 156
- 5.4 Partner's interest deductions 157 - 158
- 5.5 Working partners 159 - 161
- 5.6 Attribution of income to a working partner 162
- 5.7 Distributions 163

6. Look-through companies compared to partnerships: key points 164 – 180

- 6.1 Ownership requirements 165
- 6.2 Change of status 166

- 6.3 Income and deductions 167 - 168
- 6.4 Distributions 169 - 172
- 6.5 Working owners 173
- 6.6 Apportionment of imputation credits 174
- 6.7 Agent of absentee partner 175 - 176
- 6.8 Anti-avoidance 177 - 179
- 6.9 Corporate law differences 180

7. Companies and Limited Partnerships Amendment Acts 2014 181 – 188

8. Inland Revenue QBs on LTCs and Partnerships 189 – 190

ATTACHED PDFs:

- Comparison of qualifying company, partnership/limited partnership and look-through company tax regimes [including changes in the *Taxation (Closely Held Companies and Remedial Matters) Act 2017*];
- Inland Revenue answers to “Questions We’ve Been Asked” (“QBs”) on look-through companies (“LTCs”) and Partnerships, including answers to questions on LTC interest deductibility, tax avoidance and some issues affecting partnerships.

1.TAX RATES

1. The current company tax rate of 0.28 has applied for income years from 2011-12 onwards.
2. For the 2008-09 to 2010-11 income years, the company tax rate was 0.30. [Prior to that, for the 2007-08 income years and earlier it was 0.33.]
3. The current individual tax rates, for partners and LTC owners who are natural persons, have applied from the 2011-12 income year onwards, and are as follows:

$0 - $14,000	0.105
$14,001 - $48,000	0.175
$48,001 - $70,000	0.300
$70,001 upwards	0.330

4. Individual tax rates for the 2010-11 income year were:

$0 - $14,000	0.1150
$14,001 - $48,000	0.1925
$48,001 - $70,000	0.3150
$70,001 upwards	0.3550

2. CHANGES TO THE QUALIFYING COMPANY TAX REGIME

2.1 QC regime closed and LAQC rules repealed

5. Entry into the Qualifying Company (QC) tax regime has been closed since the 2011-12 income year. In order to be a QC:

   (a) A standard, or late, balance date company (balance date from 31 March to 30 September) must have already been in the QC regime by the end of its 2010-11 income year; and

   (b) An early balance date company (balance date from 1 October to 30 March) had to already be in the QC tax regime by the end of the 2011-12 income year.

6. The Loss Attributing Qualifying Company (LAQC) regime was repealed, with effect from an LAQC's first income year beginning on or after 1 April 2011. LAQCs that continued to meet the requirements of the QC regime became ordinary QCs, at the beginning of the 2011-12 income year (or 2012-13 for early balance date LAQCs).

7. Inland Revenue stated that existing QCs and LAQCs will be allowed to "continue to use the current QC rules without the ability to attribute losses, pending a review of the dividend rules for closely held companies" (*Tax Information Bulletin* Vol 23, No1 February 2011, page 46). There has been no such review to date and no suggestion that the QC tax regime would be repealed.

8. Transition concessions applied for the first 2 income years commencing on or after 1 April 2011 (refer to page 49 of the attached PDF on *QC/Partnership/LTC Comparison*) to allow shareholders in LAQCs, who wished to retain loss attribution to transition into any of three alternative tax regimes that continue to allow loss attribution. They are:

   - The look-through company (LTC) tax regime.
   - The partnership or limited partnership tax regime.
   - A sole tradership.

2.2 Flat-owning companies

9. A QC that is a flat-owning company could not transition into the LTC regime. It could remain a QC. The definition of a "flat-owning company" for the purposes of the QC regime was extended so as to apply to the LTC regime. A flat-owning company means a company:

(a) Whose constitution provides that every registered shareholder is entitled to the use of a specific residential property in New Zealand owned by the company; and

(b) Whose only significant assets are: residential properties available for use by specific shareholders, and funds reserved for meeting the company's costs.

2.3 Restriction on amalgamations

10. Effective from 2 November 2012, being the date of enactment of the relevant amendment act, an amalgamated company that resulted from an amalgamation between a non-QC company and a QC (i.e. an amalgamation that is not a "resident's restricted amalgamation), cannot be a QC. The amendment applies to amalgamations on or after 2 November 2012, the date of assent (see page 16 of the attached PDF on *QC/Partnership/LTC Comparison*).

2.4 Continuity of ownership requirement

11. 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 *Taxation (Closely Held Companies and Remedial Matters) 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.

12. 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.

2.5 Lifting the restriction on the intercorporate dividend exemption for ex-QCs

13. Section CW 14 denied a QC an exemption from income tax on a dividend from another company that is within the same wholly-owned group (which dividend would otherwise have been exempt from income tax under s. CW 10). Section 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.

14. This amendment is backdated to the 2005-06 income year onwards. 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.

3. KEY ASPECTS OF THE LOOK-THROUGH COMPANY TAX REGIME

15. The LTC tax regime has applied for income years commencing on or after 1 April 2011. The tax regime is very similar to that of a limited partnership. A company may convert to being a LTC for tax purposes, providing that the requirements to be an LTC are met. The requirements are set out in the definition of "look-through company" in s. YA 1 of the Income Tax Act 2007. The requirements in the definition were significantly extended effective from 1 April 2017.

3.1 Definition of "look-through company"

(Also refer to pages 5 – 12 of the attached PDF *QC/Partnership/LTC Comparison*)

16. An LTC is an entity that is described in paragraph (a) of the definition of "company", meaning a body corporate or other entity that has a legal existence separate from that of its members, whether incorporated in NZ or elsewhere. An LTC must be a tax resident of New Zealand and cannot be treated as a non-resident under any double tax agreement. An LTC need not be a company – for example, a limited partnership could elect to be an LTC for tax purposes, providing that the other requirements to be an LTC are met.

17. The owners of an LTC are referred to as "look-through counted owners" and there are special rules that apply to them and to the "look-through interests" that they have in the LTC.

18. The definition of "look-through interests" requires that the shareholders in an LTC must be natural persons. That includes natural persons acting as trustees of trusts. A company that is a corporate trustee can also be a shareholder, but only in that capacity. An LTC can be owned through another LTC.

19. Until 2017-18 income year, LTCs could have only 1 class of share. From the 2017-18 income year onwards, an LTC may have shares that carry different voting rights, providing that all shares have the same rights to distributions.

20. There must be 5 or fewer "look-through counted owners". Look-through counted owners who are relatives may be treated as one person. For the meaning of a "relative" in this context, refer to page 6 of the attached PDF on *QC/Partnership/LTC Comparison*.

21. With effect from 1 April 2017, the definition of "look-through company" has been amended so as to expressly prohibit trusts which own LTCs from making distributions to corporate beneficiaries either directly or indirectly. A trust with a corporate beneficiary may continue to be the owner of an LTC providing that no further distributions are made to the corporate beneficiary.

22. An example is provided on page 35 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 showing an indirect distribution to a corporate beneficiary. In that example, a trust that owns a LTC makes a distribution to a trust beneficiary, which in turn makes a distribution to a corporate beneficiary. The LTC will no longer be eligible to remain a LTC under such circumstances.

23. A special concessional rule applies if LTC status is lost as a result of the April 2017 amendments. See further at paragraph 35 onwards below.

24. Another amendment effective from 1 April 2017 is that LTCs are not allowed to be directly owned by tax charities (as defined in s. YA 1) or directly or indirectly owned by Māori authorities, other than "grandparented" charities and "grandparented" Māori authorities These "grandparented" charities and Māori authorities are those that had an ownership interest in, or an arrangement to become an owner of, the relevant LTC before 3 May 2016 and, in the case of a Māori authority, was a beneficiary before 3 May 2016 of a trust that owned the LTC before that date.

25. For a Māori authority, indirect ownership is also prohibited, meaning that there can be no distributions from a trust unless the Māori authority is a "grandparented" Māori authority – i.e. it was a beneficiary of the trust before 3 May 2016 and the trust also owned the LTC before that date.

26. A charity that has no influence over the LTC or trust from which they receive the distribution may receive a "no strings attached" distribution as a residual beneficiary of a trust. This will allow trusts to make genuine donations to charities.

27. These rules are interpreted on pages 35-36 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 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.

28. Another amendment, this time effective for income years beginning on or after 1 April 2017, limits the amount of foreign income that a foreign-controlled LTC is allowed to have. A foreign-controlled LTC is one that is owned more than 50% by a combination of non-residents and trusts with non-resident settlors, with a trust's percentage non-resident ownership calculated in proportion to its settlements made by non-resident

settlors. The limit on foreign income in such circumstances is the greater of $10,000 and 20% of the LTC's gross income for the year.

3.2 Look-through counted owners

(Also refer to page 9 of the attached PDF *QC/Partnership/LTC Comparison*)

29. In general, a look-through counted owner of an LTC is either a natural person with a look-through interest in the LTC, or a trustee of a trust with a look-through interest in the LTC if there is no beneficiary that is a look-through counted owner. (Until the 2016-17 income year, a trustee was counted regardless of beneficiaries if all the income from the LTC had not been distributed as beneficiary income in the current or preceding 3 years.)

30. This is then expanded by some anti-avoidance rules under which the following are included as look-through counted owners of an LTC:

    (a) A natural person who, in the current income year or one of the last 3 income years, derived beneficiary income of a trust sourced from the LTC;

    (b) A natural person with a voting or a market value interest in a company that, in the current income year or one of the last 3 income years, derived beneficiary income of a trust sourced from the LTC;

    (c) A trustee of a trust that has a direct or indirect beneficial interest in the LTC, if there is no beneficiary that is a look-through counted owner.

31. A broader anti-avoidance rule applies to trusts that own LTCs from the 2017-18 income year onwards. Under this rule, any beneficiary who receives any distribution from any source from the trust is a look-though counted owner. 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.

32. This new anti-avoidance rule is progressively incorporated into the test for determining the number of look-through counted owners (of which there can be no more than 5) over the 4 years to 2020-21. For the 3 years from 2017-18 to 2019-20, a dual test will apply involving a combination of the pre-2017-18 test and the new test for determining beneficiaries that are look-through counted owners.

33. For example, for determining whether a LTC satisfies the look-through counted owners limitation in the 2018–19 income year, a person would look at distributions provided in the 2015–16, 2016-17, 2017-18 and 2018-19 income years The pre-2017-18 test will be applied to see if there are any beneficiaries who are look-through counted owners in 2015-16 and 2016-17. Then the new rule would be applied for any distributions in the 2017–18 and 2018-19 income years to determine whether there are any additional beneficiaries that are look-through counted owners.

34. *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 contains on page 33 a Table summarising the transition, as well as three examples on pages 33-34.

3.3 Losing LTC status due to 1 April 2017 changes: transitional rule

(Also refer to page 42 of the attached PDF *QC/Partnership/LTC Comparison*)

35. Under the ordinary rules applying to LTCs, s. HB 13(4)(b) states that an election to be a LTC "is treated as not received by the Commissioner for an income year and subsequent income years if … the LTC does not meet the requirements in the definition of look-through company at all times in the income year".

36. Inland Revenue has stated on page 48 of *Tax Information Bulletin* Vol. 23, No. 1, February 2011 that this means that:

    "If an LTC breaches the eligibility criteria its LTC status is lost from the first day of the income year in which the breach occurs."

37. The continued operation of this rule has been confirmed by Inland Revenue on page 31 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017, where it is stated that:

    "No change is planned to the rule that states that if a LTC fails to satisfy the eligibility criteria during an income year it loses its LTC status from the beginning of that income year."

38. Ordinarily, when a LTC ceases to be a LTC, s. HB 4(6) provides that each owner is treated as disposing of all of their owner's interests in the LTC to a single third party for a payment equal to the interests' market value. The company is then treated as acquiring all of the owners' interests immediately after cessation, from the third party, for a payment equal to the interests' market value. For the purposes of the continued application of the land taxation rules to persons associated with the transferor under s. CB 15, the company and the owners are treated as associated persons.

39. However, where a company loses its LTC status as a result of the amendments that came into force on 1 April 2017, s. HZ 4E provides a transitional rule. Section HZ 4E applies when an entity that is a LTC at the end of the 2016–17 income year ceases to be an LTC because of an amendment to LTC-related provisions, in s. 288 of the Closely Held Companies Act. It provides that:

    (a) The market value exit adjustment in s. HB 4(6) will not apply; and

    (b) The company is treated as having the same tax position it had as a LTC.

40. It is stated on page 37 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 that this means that any assets of the LTC are transferred at book value, and the company is treated as having acquired them on the same date as the LTC and with the same intention. The following example is also provided:

    "Speculator Ltd is a LTC that is involved in property renting and speculation. On 1 May 2015, Speculator Ltd acquired land for $500,000 with the intention of reselling. Speculator Ltd sells the land on 5 August 2020 for $700,000.

    On 1 June 2017, Speculator Ltd. made a distribution to a corporate beneficiary. As a result, Speculator Ltd will lose LTC status as a result of the eligibility changes in the new rules.

When Speculator Ltd becomes an ordinary company it will be treated as having acquired the land on 1 May 2015 for $500,000 and with the intention of resale. Any increase in the value of the property will not be realised upon Speculator Ltd exiting the LTC rules. Instead any revenue account gains will be brought to account when Speculator Ltd actually sells the land – in this case on 5 August 2020 – realising a $200,000 revenue account gain."

3.4 LTC entry tax changes

(Also refer to page 14 of the attached PDF *QC/Partnership/LTC Comparison*)

41. The calculation, in s. CB 32C, of the tax payable by a person upon a company becoming a LTC has been changed with effect from the 2017-18 income year. The calculated amount is treated as a dividend with the imputation credits attached derived by the person and is taxed at the person's marginal tax rate. For a company that was a qualifying company before immediately before conversion to a LTC, the dividend is capped at the maximum dividend that could be fully imputed, consistent with the qualifying company rules.

42. As it was previously, the calculation must be made for a person for a year, and the dividend arises in that year, when either:

    (a) The person has an effective look-through interest for a LTC on the first day of the income year and the company existed in the previous year but was no a LTC in the previous year; or

    (b) The person has an effective look-through interest for a LTC on the day after it has amalgamated with a company that was not a LTC before the amalgamation.

43. For the avoidance of doubt, a new s. RE 2(5)(gb) provides that an amount treated as a dividend under section CB 32C is excluded from being a dividend for the purposes of the RWT rules – in other words, there is no need for the paying company to deduct and pay RWT in relation to the dividend that arises under s. CB 32C. There are two different ways of calculating the amount depending on whether the LTC was previously:

    (a) An ordinary company; or

    (b) A qualifying company that is unable to fully impute the dividend.

44. For a LTC that was previously an ordinary company, the formula for a person with an effective interest in the LTC on the day it commenced being a LTC is:

    (untaxed reserves + reserves imputation credit) × (the person's effective interest)

45. The amount of untaxed reserves is calculated using the formula:

    dividends – assessable income – exit exemption.

46. In the above formulae:

    (a) "Dividends" is the cash that would be dividends for tax purposes upon a notional liquidation (sale of property at market value and settlement of liabilities including tax, other than tax arising only on the notional liquidation), immediately before the company either became a LTC or amalgamated with a LTC, that is distributed without any imputation credits attached to the company's shareholders;

(b) "Assessable income" is the total assessable income that the company would derive by taking the above actions required to determine the cash available for distribution, reduced by any tax deduction that the company would have for taking those actions;

(c) "Exit exemption" is the exempt dividend calculated under s. CX 63 if the company had been a LTC at some time in the past (essentially retained reserves from the previous LTC period that have not since been distributed); and

(d) "Reserves imputation credit" is the total amount of credits in the company's imputation credit account (increased by tax unpaid and reduced by refunds due for an earlier income year), up to the maximum permitted ratio for the untaxed reserves under s. OA 18 and is treated as an attached imputation credit included in the dividend calculated.

47. The deduction for assessable income essentially provides a reduction from the "entry" dividend for amounts derived from disposals of property that would be eventually taxed when the property is actually disposed of. Consistent with this, new s. HB 13(6) clarifies this point and provides that:

"An entity that ceases to be a company upon becoming an LTC is treated as having, as an LTC, the same status, intention, purpose, and tax book values it had as a company for its assets, liabilities, and associated legal rights and obligations."

48. This means that, for example, revenue account property is transferred at tax book value, and not market value, meaning that unrealised gains and losses are not recognised upon the company becoming a LTC. Instead, the LTC is treated as stepping into the shoes of the company. For example, if a company acquired land with an intention of resale and subsequently converts to a LTC, the LTC will be treated as also acquiring the land on the same date with an intention of resale.

49. For a LTC that was previously a qualifying company, the formula for a person with an effective interest in the LTC on the day it commenced to be a LTC is:

[(balances ÷ tax rate – balances) + balances] × (the person's effective interest)

50. Where:

(a) "Balances", measured on the last day of the income year immediately before the qualifying company commenced being a LTC or on the day it amalgamated with a LTC, is the balance in the company's imputation credit account plus unpaid income tax for an earlier income year (that would result in credits to the imputation credit account if paid) less refunds due for an earlier income year (that would result in debits to the imputation credit account if received); and

(b) "Tax rate" is the the tax rate that applied on the last day of the income year immediately before it commenced being a LTC or on the day it amalgamated with a LTC.

51. In effect, this formula calculates the taxable dividend (excluding imputation credits) as the amount that could be fully imputed by the qualifying company. Any amount in excess of this is an exempt dividend, consistent with the qualifying company rules.

52. A detailed example is provided on page 40 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 and is reproduced in *Weekly Comment* 13 October 2017.

3.5 Deduction limitation rule

(Also refer to pages 24 & 36 of the attached PDF *QC/Partnership/LTC Comparison*)

53. With effect from the 2017-18 income year, the application of the LTC deduction limitation rule is limited, by an amendment to s. HB 11(1), to:

    (a) An LTC in a partnership that includes another LTC; or

    (b) An LTC that is a member of a joint venture, as described in s. HG 1, that includes another LTC.

54. This means that there is no longer any limitation on deductions for an LTC that is not in a partnership or a joint venture with another LTC. In addition, all previous deductions denied and carried forward may be deducted in the 2017-18 income year, under s. HB 12(2) and s. HB 12(3).

55. The formula determining the "owner's basis" in s. HB 11 will otherwise be unchanged.

56. In order to bolster the application of the deduction limitation rule to a LTC in partnership or in a joint venture with another LTC, the anti-avoidance rule in s. GB 50 that applied to a partner in a partnership has been extended so that it applies to an owner of an LTC.

57. Section GB 50 was enacted together with the tax rules applying to limited partnerships. It provided that when a partner of a partnership entered into an arrangement involving a consideration that was not market value, and the arrangement had a purpose or effect of defeating the intent and application of the tax rules in subpart HG applying to limited partnerships, a market value consideration is substituted for the non-market consideration.

58. It was stated in *Tax Information Bulletin* Vol. 20 No. 8, September/October 2008, on page 6 that:

    "Transactions that do not occur at market value, such as goods provided at a discount, are likely to have an impact on limited partners' partnership basis, with excess value given to a partnership being treated as a capital contribution, and excess value received from a partnership being treated as a distribution."

59. It was stated further on page 11 of the *Commentary* released when the partnership tax rules were introduced that:

    "(Section GB 50) provides that transactions between partners (except salary payments) will be treated as being at market value for tax purposes. This rule applies to partners acting as members of the partnership.

    Salaries are excepted because it is common in professional partnerships that partners' salaries are not set at market value, with the bulk of their income coming from their share of the partnership's income. Therefore a blanket rule would be inappropriate for salary and wages. In case of abusive manipulation of salary and wages, the Commissioner can still use other provisions such as the general anti-avoidance provisions. …

Transactions between partners are either explicitly or implicitly required to be at market value. For example, the existing rule on rent transactions effectively requires the transaction to be made at market value for tax purposes, and the requirement for arm's length transactions is implicit in the requirements of section DC 4 in relation to contracts of service. The proposed amendment applies to all transactions between partners and partnerships, other than the payment of wages and salaries."

60. With effect from 1 April 2017, s. GB 50 also applies to a LTC owner that enters into an arrangement involving a consideration other than market value and the arrangement has a purpose or effect of defeating the intent and application of subparts HB and HG.

61. Based on the explanations provided at the time s. GB 50 was enacted, as discussed above, it will only apply if there is an impact on the owner's basis which, from the 2017-18 income year, will only be relevant for a LTC in a partnership or joint venture with another LTC.

3.6 Self-remission of LTC debts

(Also refer to page 28 of the attached PDF *QC/Partnership/LTC Comparison*)

62. Rules relating to the tax treatment of debts that are "self-remitted" were enacted on 30 March 2017 and apply for income years beginning on or after 1 April 2011.

63. A creditor is ordinarily denied a deduction for any amount remitted (i.e. forgiven) by including the remitted amount in the amounts received by the creditor, thereby removing the negative effect of the remitted amount from the base price adjustment ("BPA"). The debtor is, however, taxed on the amount remitted.

64. A similar result occurs if a financial arrangement is disposed of for a consideration less than market value due to a decline in the debtor's creditworthiness or because the debtor's obligations have been reduced or cancelled. The creditor is deemed to have been paid the market value under s. EW 39, thereby eliminating a negative consideration for the purposes of the BPA.

65. Where an LTC owner is both a creditor (due to having advanced an amount to the LTC) and a debtor (because of the attribution of the LTC's debt to the owner), the above rules result in an unfair amount of taxation. This is because the owner as debtor has income, whereas the owner as creditor is denied an equivalent deduction.

66. Section DB 11(1B) permits a deduction for "self-remission" as follows:

    "A person who has a negative base price adjustment under section EW 31(4) for a financial arrangement is allowed a deduction for an amount of the negative base price adjustment up to the maximum of their amount of *self-remission* for the financial arrangement." (emphasis added)

67. The LTC owner/lender's position is remedied under the new rules in s. DB 11(1B), s. EW 31(11) and s. EW 39(4). A deduction is permitted to the creditor/lender for "self-remission" by:

    (a) Allowing a deduction for a negative BPA resulting from "self-remission" under s. DB 11(1B);

(b) Excluding "a remission that is self-remission" from being "remission" for the purposes of the add-back in the BPA formula under a replacement definition of 'remission" in s. EW 31(11); and

(c) Subtracting the amount of "self-remission" from market value for the purposes of calculating the BPA upon disposal of a financial arrangement, under new s. EW 39(4).

68. For an interest-free loan in New Zealand currency repayable on demand, which would be an excepted financial for the creditor/lender under s. EW 5(10) and to which, therefore, the above amendments would not apply, an amendment to s. EW 8 allows "a person to treat as financial arrangements … any excepted financial arrangement to which the person is a party that is described in s. EW 5(10)".

69. "Self-remission" means, for a person:

(a) For the purposes of the BPA formula in s. EW 31(11), a remission amount for a financial arrangement under which, and to the extent to which, because of the operation of s. HB 1 (the LTC rules) or s. HG 2 (the limited partnership rules), the person is also liable as debtor in their capacity of owner or partner;

(b) For the purposes of determining market value upon disposal of a financial arrangement under s. EW 39(4), the amount by which the consideration for the disposal of a financial arrangement is affected by a factor described in section EW 39(1)(d), to the extent to which:

(i) The disposal occurs upon cessation of a LTC or dissolution of a partnership under s. HB 4(3) or (6) or s. HG 4; and

(ii) Immediately before the disposal, the person is also liable as debtor in their capacity of owner or partner because of the operation of s. HB 1 or s. HG 2.

70. Paragraph (a) if the above definition means that a shareholder or partner of a LTC or partnership will have a negative base price adjustment in their capacity as a creditor that neutralises out any income attributed to them as debtor in their capacity as owner or partner.

71. An example is provided on page 43 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 of an LTC with 2 owners with equal 50% ownership interests, Shareholder A, who has lent $100 to the LTC, and Shareholder B who has not lent the LTC any money. Shareholder A subsequently remits the $100 debt it owes to the LTC. The effects for each shareholder are set out in the example.

72. Another example is provided on page 44 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 of how the amendment allowing subtraction of the amount of "self-remission" from market value for the purposes of calculating the BPA upon disposal of a financial arrangement, under new s. EW 39(4) will work. It is noted on page 43 of the TIB Item that for a LTC, this can occur upon permanent cessation, capital reduction, or revocation of LTC status. For partnerships this can occur on sale of partnership interests by a partner or upon dissolution of a partnership.

73. Both examples are reproduced in *Weekly Comment* 20 October 2017.

3.7 Taxation of debts forgiven by third parties

(Also refer to page 29 of the attached PDF *QC/Partnership/LTC Comparison*)

74. Rules have been introduced to ensure that LTC owners are taxed on debts forgiven by third parties. Section HB 4 contains the general provisions relating to disposals of LTCs. A new s. HB 4(7) provides that the market value of an owner's interest in a financial arrangement as debtor must take into account the amount of any adjustment for credit impairment.

75. It is stated on page 44 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 that this ensures the debt remission rules work as intended so that when a debtor sells their interest in a financial arrangement that they will not be able to repay in full, they are treated the same as if the amount they are unable to repay was remitted. The new rule is explained on page 44 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 as follows:

    "Under the new rules, debtors will not need to rely on information from the creditor to determine the amount of credit impairment. Instead, the debtors will need to make a fair and reasonable estimate of the credit impairment based on the information they have available.

    To determine the credit impairment, the key question to ask is "if the LTC was sold or liquidated, how much of the debt would be repaid to the creditor?" In most cases, determining this would involve looking at the balance sheet of the LTC to determine the net assets of the LTC."

76. An example is provided on page 44 *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 and is reproduced in *Weekly Comment* 20 October 2017.

77. This rule applies from 1 April 2011 (i.e. from the inception of the LTC tax regime). However, to avoid reopening past returns, any additional income and associated penalties and interest from those earlier years is brought to account in 2017–18 income returns by way of a new transitional rule in s. HZ 8.

78. The formula in s. HZ 8 requires taxpayers to revisit all past LTC disposals involving financial arrangements and apply the new rule to calculate revised income under a revised BPA. This is referred to as the "retrospective amount".

79. This "retrospective amount" is then compared to the actual income returned on disposals of financial arrangements before the 2017-18 income year, referred to as "current income".

80. The difference between the "retrospective amount" and the "current amount" will be income in the 2017-18 income year.

3.8 LTCs distinguished from owners: LTC Elections

(Also refer to page 19 of the attached PDF *QC/Partnership/LTC Comparison*)

81. Under s. HB 1(6), all elections and methods that are chosen for tax purposes are chosen by the LTC itself, and then those elections and methods apply to the LTC owners when returning income and deductions attributable to them from the LTC.

3.9 LTCs distinguished from owners: LTCs and financial arrangements

82. The general rule in section HB 8 is that when an LTC owner disposes of an interest in an LTC, unless the disposal is because the LTC ceases to be an LTC or ceases to exist or the LTC's capital is reduced, the LTC's financial arrangements are ignored, and the entering owner is treated as if they always held the financial arrangement. The exiting owner is not required to perform a base price adjustment.

83. The application of this rule depends on no income being derived by the LTC from a business of holding financial arrangements. Note, however, that if the LTC ceases to exist, s. EW 29(14) requires a person that is party to the financial arrangement in their capacity as owner to calculate a base price adjustment if they are also a party to the financial arrangement in a private capacity.

3.10 LTCs distinguished from owners: CFC and FIF interests

84. Where an LTC holds a control interest and an income interest in a CFC, the better view is that all shareholders with an effective interest in the LTC hold interests in a CFC (and not in a FIF), regardless of the individual proportionate interests of the LTC owners.

85. The same rule should apply in respect of a limited partner's interest in a CFC held by the limited partnership.

86. The basis for this is s. HB 1(4)(b) in the case of an LTC, and s. HG 2(1)(b) in the case of a limited partnership. These sections state that an LTC owner or a partner, as the case may be*, is treated as holding property that the LTC or partnership, holds* in proportion to the person's effective look-through interest or partner's partnership share. It is the property held by the LTC or partnership that becomes the property held by the LTC owner or partner.

87. Further support for this viewpoint can be obtained from the following:

    (a) Section EX 13 that was repealed effective from 1 April 2008 previously stated that the section applied "when a partnership holds rights that would be an income interest in a CFC if the partnership were an individual." In that case, each partner was treated as holding a share of what was held by the partnership in proportion to the partner's interest in the partnership.

    (b) Section EX 30(8) concerns the calculation of the direct income interest in a FIF for a partnership and states that:

    "In this section, *if a partnership holds any rights*, each partner is treated as holding a share of those rights in proportion to the partner's interest in the partnership." (emphasis added)

    (c) The rule in s. HB 1(6), which states that Inland Revenue Act elections and methods relating to an LTC are chosen by the company.

3.11 GST grouping

88. LTCs are able to use the GST group registration rules.

3.12 Payments to a working owner

(Also refer to pages 34-37 of the attached PDF *QC/Partnership/LTC Comparison*)

89. A deduction for payments to a working owner is only permitted if there is a contract of employment, in writing that specifies the terms and conditions and the amount payable, and is signed by all parties.

90. Fringe benefits provided to a working owner will not be subject to FBT under the definitions of "employer" and "employee". An LTC is excluded from being an employer of a "working owner" for FBT purposes.

91. The anti-avoidance rule in section GB 32, that applies so as to treat a benefit that is provided to a person who is associated with an employee as a fringe benefit provided to the employee will not apply, effective from 2 November 2012, when:

    (a) The employer is an LTC or a partnership or a limited partnership; and

    (b) The person associated with the employee is an owner of the LTC or a partner in the partnership or limited partnership.

92. An LTC is treated as a separate taxpayer when applying the income attribution rules in sections GC 27 to 29.

3.13 Treatment of disposals and safe harbour rules

(Also refer to pages 42-44 of the attached PDF *QC/Partnership/LTC Comparison*)

93. A payment to an LTC owner, for a disposal of the owner's interest in the LTC, may be taxable on general principles, subject to the application of specified safe harbour limits.

94. The general safe harbour rule is that the gain on disposal, (calculated using the tax book values of revenue account property, depreciable property and financial arrangements), must be less than $50,000. There are also specific safe harbour rules.

3.14 Tax filing obligation and tax disputes process

(Also refer to pages 45-47 of the attached PDF *QC/Partnership/LTC Comparison*)

95. An LTC has to file an annual tax return, showing the income and deductions of the LTC, and the allocations to the LTC's owners.

96. Elections concerning the tax treatment of an LTC's income or property, or any valuation or timing methods adopted in relation to an LTC's income or property, are made or established by the LTC, not each owner. The elections made, or valuation and timing methods adopted, by the LTC are then binding on the owners in respect of their look-through interests in the LTC's property.

97. Only an LTC may propose adjustments in a NOPA and complete the disputes process in connection with a tax position taken in an LTC's tax return. An owner can challenge an assessment relating to income from an LTC once the LTC has completed the disputes process.

98. The LTC's tax return is treated as if it were a return by each owner for the purpose of applying shortfall penalties for an unacceptable tax position. An LTC could also possibly be regarded as a "group of persons", under section 94B of the *Tax Administration Act*

1994, for the purpose of applying shortfall penalties generally to LTC owners in proportion to their interests in the LTC.

3.15 Deduction of an owner's interest expenditure
(Also refer to page 31 of the attached PDF *QC/Partnership/LTC Comparison*)

99. The deductibility of an owner's interest expenditure, on money borrowed to acquire shares in an LTC, is not affected by the owner's basis even if an LTC is in a partnership or joint venture with another LTC. This is because the interest deduction is not an LTC attributed deduction.

100. The Commissioner's statement in QB 11/03 *Income tax: Look-through companies and interest deductibility* that "the LTC regime does not operate to substitute the owner's actions for those of the LTC" clearly implies that an amount borrowed by an owner to invest in an LTC will not be regarded as an amount borrowed by the LTC itself. Therefore an LTC owner should be able to deduct interest on money borrowed to invest in an LTC if that meets the general permission requirements in section DA 1. The capital limitation in section DA 2 will not apply. The deduction limitation rules that apply to LTC partnerships and LTC joint ventures only apply to deductions attributed from LTCs, so they will not apply to an owner's interest deductions in a personal capacity.

3.16 LTC income and deductions
(Also refer to pages 21 & 23-31 of the attached PDF *QC/Partnership/LTC Comparison*)

101. An LTC owner's proportionate allocation, of the LTC's income and deductions, is based on the owner's daily average interest in the LTC for the year. However, if an LTC's income is at least $3 million, the owners can choose to base allocations on owners' interests at particular times during the year, provided that this method of allocation is used by all LTC owners. The Commissioner can require that allocations be based on an owner's interests at particular times during the year if an LTC's income is at least $3 million.

102. An LTC's gross income is attributed to its owners in the same way as a partnership's income is attributed to the partners.

103. A net loss of an LTC is attributed to the owners, by attributing LTC deductions in excess of LTC gross income. The ability of the owners to deduct that loss is no longer restricted, unless the LTC is in a partnership or a joint venture with another LTC.

104. For an LTC that is in a partnership or a joint venture with another LTC:

    (a) An owner's attributed deductions from the LTC for a year, can only be deducted to the extent of the "owner's basis" at the end of that year;

    (b) The owner's basis is a means of limiting LTC deductions in excess of LTC income, to the amount of the owner's net investment in the LTC (i.e. investment net of LTC distributions);

    (c) LTC deductions in excess of LTC income progressively reduce the owner's basis, until it is equal to the gross income from the LTC each year, and once that happens, the owner's LTC deductions are limited to income from the LTC for the year;

    (d) LTC deductions that are not allowed due to an insufficient owner's basis, can be carried forward and used in a later year when there is a sufficient owner's basis; and

(e) If an LTC ceases to exist, or ceases to be an LTC, any remaining excess deductions are lost.

3.17 Distributions from an LTC
(Also refer to pages 38-39 of the attached PDF *QC/Partnership/LTC Comparison*)

105. LTC distributions include all payments by the LTC that are not payments to a working owner.

106. A distribution by way of a share repurchase is treated as a disposal of part of an owner's interest and the rules for disposals apply.

107. Distributions by an LTC in a partnership or a joint venture with another LTC will reduce the LTC's owner's basis.

3.18 Valuation of an owner's investment in an LTC
(Also refer to page 25 of the attached PDF *QC/Partnership/LTC Comparison*)

108. For an LTC in a partnership or joint venture with other LTCs, the valuation of an owner's investment in the LTC is an important aspect of determining the owner's basis. The general rule is that an owner's investment is: the market value of the owner's shares in the LTC at the time they were acquired, plus loans made to the LTC plus "secured amounts".

109. The extent to which "secured amounts" are allowed to be included in "Investments" for the purpose of calculating an owner's basis is limited as follows:

(a) "Secured amounts" do not include an amount that the LTC is debtor for in relation to another person if that other person has included that amount in that other person's "Investment".

(b) "Secured amounts", for a person, is limited to the proportion of (LTC or limited partnership) debt that the person (and "owner's associates" of the person) is guarantor for, taking into account all third party guarantors for the same debt.

(c) Where a guarantee or indemnity expressly provides recourse only to certain property, the "secured amount" is limited to the proportional interest in the market value of the recourse property that the person (and "owner's associates" of the person) has, net of higher-ranking calls that are actual, future or contingent, taking into account the proportional interests in the recourse property of all third party guarantors.

110. For this purpose, "owner's associate" refers to persons who are not themselves owners of the LTC or partners in the limited partnership, and are either relatives of the person or a trustee associated – in their capacity as trustee – with the person. A relative does not include a trustee of a trust in which a relative has benefited or is eligible to benefit.

3.19 FIF Income

111. When determining a person's "Income" for the purpose of calculating the person's owner's basis, dividends received from FIFs, that are treated as not being dividends under section CD 36(1), are included in the calculation of "Income" based on the following rules:

(a) If the person's share of FIF dividends is less than the FIF income of the person, the FIF dividends are ignored.

(b) If the person's share of FIF dividends exceeds the person's FIF income, the dividends are included in "Income" to the extent of the excess.

(c) If the person has a FIF loss, the person's "Income" includes the whole of the person's share of FIF dividends.

3.20 Deduction of losses carried forward from a QC

(Also refer to page 50 of the attached PDF *QC/Partnership/LTC Comparison*)

112. Losses carried forward from a QC are attributed to an LTC's owners. The ability to deduct such losses is not limited by the owner's basis. However, the losses can only be set off against income from the LTC: either net income from an LTC, or income from the LTC that has resulted due to LTC deductions disallowed because of an insufficient owner's basis.

4. QUALIFYING COMPANIES COMPARED TO LOOK-THROUGH COMPANIES: KEY POINTS

113. There are some important differences between an LTC and a QC.

4.1 Ownership requirements

(Refer to pages 7 to 9 and 11 of the attached PDF on *QC/Partnership/LTC Comparison*)

114. There are some significant differences in the shareholding requirements as between a QC and an LTC. The rules on the rights carried by shares are stricter for an LTC than for a QC.

115. For a QC, shareholders who are relatives within the first degree of relationship are treated as one person. For an LTC, shareholders who are relatives within the second degree of relationship are treated as one person.

116. From 2 November 2012, a "relative" for the purposes of aggregating interests in an LTC, excludes a person connected with another person by being the trustee of a trust under which a relative has benefited or is eligible to benefit.

117. Up until the 2016-17 income year, the voting rights carried by every share in an LTC had to be identical. From the 2017-18 income year, share in an LTC may carry different voting rights. However, every share must carry the same rights to distributions. By contrast, there are no specified requirements for rights carried by the shares in a QC.

118. A trustee that holds shares in a QC is not counted as a shareholder in the QC. A trustee is not allowed to hold shares in a QC unless all dividend income from the QC (excluding non-cash dividends) is distributed as beneficiary income. By contrast, a trustee can be a shareholder in an LTC, and is counted, but only if there is no beneficiary who is a look-through counted owner. In terms of how beneficiaries are counted, from the 2017-18 income year onwards, counted beneficiaries include any natural person who has received

any distribution (whether or not it is sourced from the LTC), and there are some transitional phasing-in rules (see page 9 of the attached pdf).

119. There are a number of restrictions on a trustee shareholder in an LTC, whereas there are no similar restrictions on a trustee shareholder in a QC:

   (a) A trustee shareholder in an LTC cannot make distributions to a corporate beneficiary;

   (b) A trustee shareholder in an LTC cannot be a tax charity or a Maori authority unless it is "grandparented" (see page 5 of the attached pdf).

120. As already noted (in paragraph 13), flat-owning companies cannot be LTCs, but they can remain QCs.

121. The shareholders in a QC are liable for the income tax of the QC, whereas LTC owners are liable only for their own income tax.

4.2 Income and deductions

(Refer to pages 14 and 21 of the attached PDF on *QC/Partnership/LTC Comparison*)

122. The main difference between a QC and an LTC that a QC is taxed as a company and pays dividends, whereas an LTC is a look-through entity, and its owners are liable for income tax in their own right, on income and deductions attributed from the LTC.

123. Restrictions have always applied to foreign dividend income and CFC or FIF holdings for a QC. While there are no restrictions on CFC or FIF holdings for an LTC, for income years beginning on or after 1 April 2017 restrictions apply to foreign-sourced income of an LTC if more than 50% of the ownership interests in the LTC are held by "foreign LTC holders".

4.3 Tax rate

(Refer to page 22 of the attached PDF on *QC/Partnership/LTC Comparison*)

124. The company tax rate applies to a QC. Dividends are taxable only to the extent they are fully imputed, at the shareholders' relevant marginal rates. Unimputed dividends are exempt income in the hands of shareholders.

125. An LTC's shareholders are taxed on gross income less allowed deductions from the LTC at their relevant marginal rates.

4.4 Loss attribution

(Refer to page 24 onwards of the attached PDF on *QC/Partnership/LTC Comparison*)

126. QC losses cannot be attributed to shareholders.

127. LTC deductions are attributed to owners. With effect from the 2017-18 income year, there is no limitation on deductions by an LTC owner of deductions attributed from the LTC, unless the LTC is in a partnership or joint venture with another LTC. If the LTC is in a partnership or joint venture with another LTC, deductions attributed to an owner can only be deducted if the owner has a sufficient owner's basis – referred to as the "deduction limitation" rules.

4.5 Debt remission rules

(Refer to pages 28-29 of the attached PDF on *QC/Partnership/LTC Comparison*)

128. When a debt owed by a QC is forgiven within the same wholly-owned group of companies, it is treated as having been paid. If forgiven by a creditor that is not in the same wholly-owned group of companies as the QC, the creditor's "proportional ownership ratio" must be the same as the "proportional debt ratio" in order for the amount forgiven to be treated as repaid.

129. When an LTC owner wholly remits a debt owed by the LTC, a "self-remission" rule allows the owner a tax deduction for the amount remitted. For a partial debt remission, the LTC and an LTC owner are deemed to have paid and received, respectively, the amount forgiven if the owner's "proportional ownership ratio" is the same as the owner's "proportional debt ratio".

130. Forgiveness of an LTC's debt by third parties is not self-remission and remains taxable. A rule introduced in 2017-18 applies retrospectively to tax an LTC owner, upon disposal of an LTC, on any portion of a debt that an LTC is not able to repay in full.

4.6 QC and LTC interest deductions

(Refer to page 30 of the attached PDF on *QC/Partnership/LTC Comparison* and the attached PDF on *Interest deductibility by LTCs*)

131. Interest deductibility by QCs requires a nexus with income under the general permission in section DA 1. However, the capital limitation in section DA 2 does not apply. QCs are not allowed an automatic deduction for interest.

132. An LTC is allowed a deduction for interest for money borrowed for the purposes of deriving its assessable income. The Commissioner has stated in QB 11/03 *Income tax: Look-through companies and interest deductibility* that the use of borrowed funds by an LTC owner in a personal capacity is separate from the use of such funds in their capacity as LTC owner.

133. The Commissioner has discussed LTC interest deductions in two further "Questions We've Been Asked": QB 12/08 *Look-through companies: interest deductibility on funds borrowed to repay shareholder current accounts* and QB 12/09 *Look-through companies: interest deductibility where funds are borrowed to make a payment to shareholders to reflect an asset revaluation*.

134. In these QBs the Commissioner maintains that the rules governing interest deductibility in partnerships, as set out in the Australian case of *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4 and discussed in the commentary to Public Rulings *BR Pub 10/14 – 10/19*, are relevant in determining LTC interest deductions that can be attributed to LTC owners.

4.7 Shareholder interest deductions

(Refer to page 31 of the attached PDF on *QC/Partnership/LTC Comparison*)

135. Interest deductions of QC shareholders, on money borrowed to acquire shares in the QC, must be reduced by non-cash dividends received. This does not apply to LTC owners.

136. The Commissioner's statement in QB 11/03 *Income tax: Look-through companies and interest deductibility* that "the LTC regime does not operate to substitute the owner's actions for those of the LTC" implies that an amount borrowed by an owner to invest in an LTC will not be regarded as an amount borrowed by the LTC itself. Therefore an LTC owner should be able to deduct interest on money borrowed to invest in an LTC if that meets the general permission requirements in section DA 1. The capital limitation in section DA 2 will not apply. The deduction limitation rules only apply to deductions attributed from LTCs, so they will not apply to an owner's interest deductions in a personal capacity.

4.8 Payments to shareholder-employees

(Refer to pages 34 and 37 of the attached PDF on *QC/Partnership/LTC Comparison*)

137. There are no special rules governing payments to a shareholder-employee in a QC. There are specified rules on the employment contract between a working owner and an LTC, in order for payments to the working owner to be deductible.

138. Effective from 30 March 2017, The PAYE rules do not apply to income from employment derived by a shareholder-employee in a QC if:

    (a) They do not derive salary or wages:

        (i) Of a regular amount for regular pay periods of one month or less throughout the income year; or

        (ii) That total 66% or more of their annual gross income as an employee for the year; or

    (b) An amount is paid as income that may later be allocated to them as an employee for the income year.

139. A new rule, effective from 30 March 2017, provides for a combination of PAYE tax deductions and provisional tax in relation to amounts paid to a shareholder-employee in a QC as follows:

    (a) Payments of salary or wages of a regular amount for regular pay periods derived as an employee are treated as PAYE income payments; but

    (b) All amounts paid as income that may be later allocated to the shareholder-employee as an employee for the income year are treated as income other than from a PAYE income payment.

140. Switching between the above two methods (non-PAYE vs combination of PAYE and non-PAYE) is not allowed. A shareholder-employee who has elected to use one of the above two methods, who subsequently changes to using the other of the two methods, is locked out of any subsequent changes for three income years.

141. The shareholder-employee's income remains employment income for the purposes of other provisions in the Act and an amendment in the *Annual Rates Tax Act* clarifies that. (See page 34 of the attached PDF on *QC/Partnership/LTC Comparison*)

142. The PAYE rules apply to payments from an LTC to a working owner. The payments are included in the working owner's salary or wages.

143. A benefit provided by a QC to an employee under the FBT rules is a fringe benefit and will be subject to FBT. By contrast, FBT will not apply to fringe benefits received by a "working owner" of an LTC. A "working owner" is excluded from being an employee for FBT purposes and an LTC is excluded from being an employer of a "working owner" for FBT purposes.

144. The cost of providing a fringe benefit as well as the FBT paid is tax deductible to a QC. By contrast, the cost to an LTC of providing a benefit to a working owner is a distribution of profit to the working owner, to the extent of the private use element. The private use costs are non-deductible to the other owners.

4.9 Attribution of income to a working person

(Refer to page 35 of the attached PDF on *QC/Partnership/LTC Comparison*)

145. Both a QC and an LTC are required to attribute income to a working person if the criteria for attribution are met. A QC, however, is able to limit a working person's interest and/or penalties by transferring overpaid provisional tax to the working person.

146. By contrast, a working owner of an LTC is paid salary or wages from which PAYE tax is deducted. Under s. CE 8, the attributed amount is allocated to the income year in which it is attributed. This would result in a provisional tax obligation for the working person, and the other LTC owners will be entitled to refunds of overpaid provisional tax. An arrangement would have to be entered into between the working owner and the other LTC owners to transfer provisional tax under sections 173P-173R of the *Tax Administration Act 1994*. This is not straightforward – refer to the examples in *Tax Information Bulletin* Vol. 14, No. 11, November 2002, pages 35-48.

4.10 Dividends and capital reductions

(Refer to pages 38 - 39 of the attached PDF on *QC/Partnership/LTC Comparison*)

147. Dividends paid by QCs are subject to company law rules, as are distributions (dividends) from an LTC to an owner.

148. The general rules on capital reductions apply to QCs. Pro rata capital reductions by an LTC will reduce the owner's basis of LTC owners. A non-pro rata capital reduction by an LTC is treated as a disposal of the owner's interests, and the rules for disposals of owners' interests will apply. Company law rules on capital reductions apply to both QCs and LTCs.

4.11 Losing status

(Refer to pages 41-42 of the attached PDF on *QC/Partnership/LTC Comparison*)

149. If QC status is lost, the consequence is that the shareholding continuity rules apply to the carry forward of remaining imputation credits as if they had always applied. Therefore, all remaining imputation credits must be extinguished by corresponding debits to the extent that the required 66% shareholding continuity has not been maintained in respect of those credits.

150. There could be significant tax consequences for LTC owners if LTC status is lost. However, a transitional rule applies if LTC status is lost as a result of the amendments that came into effect on 1 April 2017.

5. QUALIFYING COMPANIES COMPARED TO PARTNERSHIPS: KEY POINTS

151. There are significant differences between a QC and a partnership.

5.1 Ownership requirements

(Refer to pages 5 to 9 of the attached PDF on *QC/Partnership/LTC Comparison*)

152. A key difference between a QC and a partnership is that there is no restriction on the number of people, or the type of person, who can be partners. However, it is possible for a QC to have a single owner, whereas a partnership must have at least two partners.

153. A limited partnership must have a general partner who is:

   (a) A natural person who lives in New Zealand, or another limited partnership with a general partner who is a natural person who lives in NZ, or an ordinary partnership with a partner who is a natural person who lives in NZ, or in all three cases, is a natural person who lives in an "enforcement country" and is a director of a company registered in that enforcement country; or

   (b) A company registered in New Zealand or an overseas company registered in NZ, in either case, with one or more directors who are natural persons who live in NZ or is a natural person who lives in an "enforcement country" and is a director of a company registered in that enforcement country.

154. While not an "ownership requirement", a QC must have a director who lives in New Zealand or lives in an 'enforcement country" and is a director of a company registered in that enforcement country.

5.2 Income and deductions

(Refer to pages 21 and 23 - 27 of the attached PDF on *QC/Partnership/LTC Comparison*)

155. The income and deduction distinctions between a QC and a partnership are the same as those already noted between a QC and an LTC. There are no income restrictions for a partnership. The individual partners are taxed on income and deductions from the partnership. The deduction limitation rules only apply to limited partners.

5.3 Partnership interest deductions

(Refer to page 30 of the attached PDF on *QC/Partnership/LTC Comparison*)

156. The Commissioner has set out the rules governing interest deductibility in partnerships, essentially taken from the judgment in the Australian case of *FC of T v Roberts*; *FC of T v Smith* 92 ATC 4 in Public Rulings *BR Pub 10/14 – 10/19*.

5.4 Partners' interest deductions

(Refer to page 31 of the attached PDF on *QC/Partnership/LTC Comparison*)

157. Partners' interest deductions on money borrowed to invest in the partnership are not reduced by benefits in kind received from the partnership, as is the case with shareholders in a QC.

158. A partner or a limited partner should be able to deduct interest on money borrowed to invest in a partnership or limited partnership if that meets the general permission requirements in section DA 1. The capital limitation in section DA 2 will not apply. The deduction limitation rules only apply to deductions attributed from limited partnerships, so they will not apply to a limited partner's interest deductions in a personal capacity.

5.5 Working partners

(Refer to pages 34 and 37 of the attached PDF on *QC/Partnership/LTC Comparison*)

159. Payments to a working partner are included in the working partner's salary or wages from which PAYE tax must be deducted. Refer to the comments in paragraphs 137 to 144 for the treatment of employment income paid to a shareholder-employee of a QC.

160. There are specified requirements for the service contract between a working partner and a partnership, in order for payments to the working partner to be deductible.

161. Benefits in kind provided to a working partner are not subject to FBT.

5.6 Attribution of income to a working partner

(Refer to page 35 of the attached PDF on *QC/Partnership/LTC Comparison*)

162. The situation is similar to that for an LTC. Refer to paragraphs 145 to 146.

5.7 Distributions

(Refer to pages 38 - 39 of the attached PDF on *QC/Partnership/LTC Comparison*)

163. Company law governs the payment of dividends by a QC. The *Limited Partnerships Act 2008* ("LPA") governs distributions by a limited partnership. A pro rata reduction in partners' contributions is a distribution under section 38 of the LPA, and will reduce a partner's basis. The disposal rules should apply to a non-pro rata reduction in a partner's interest. The disposal rules also apply when a partnership is dissolved.

6. LOOK-THROUGH COMPANIES COMPARED TO PARTNERSHIPS: KEY POINTS

164. The LTC tax regime has been modeled on the tax regime for limited partnerships, but there are some differences.

6.1 Ownership requirements

(Refer to pages 5 to 9 of the attached PDF on *QC/Partnership/LTC Comparison*)

165. The main difference is that an LTC can have a single owner, but a partnership must have at least 2 partners. Additionally, any person may be a partner or a limited partner, whereas there are restrictions on who can be a look-through counted owner of an LTC. (Note the restrictions on general partners in a limited partnership referred to in paragraph 153 above.)

6.2 Change of status

(Refer to page 41 of the attached PDF on *QC/Partnership/LTC Comparison*)

166. An LTC can change its status and become an ordinary company if the election(s) to be an LTC are revoked. Such an option is not available to a limited partnership.

6.3 Income and deductions

(Refer to pages 21 & 23 - 27 of the attached PDF on *QC/Partnership/LTC Comparison*)

167. LTC owners are taxed on income and deductions from the LTC. Similarly, the individual partners in a partnership are taxed on income and deductions from the partnership.

168. For an LTC, with effect from the 2017-18 income year, there are no deduction limitation rules that apply to the LTC's owners, unless the LTC is in a partnership or a joint venture with another LTC. Deduction limitation rules apply to the limited partners in a limited partnership. The deduction limitation rules do not apply to an ordinary partnership.

6.4 Distributions

(Refer to pages 38 - 39 of the attached PDF on *QC/Partnership/LTC Comparison*)

169. For a limited partnership, distributions are relevant for the purposes of determining an owner's basis. "Distributions" are:

"the total of -

(a) the market value of distributions to the partner from the limited partnership:

(b) the amount paid to the partner for the assignment of capital contributions by them."

170. For an LTC, the determination of an owner's basis is no longer relevant, except for an LTC that in a partnership or a joint venture with another LTC. "Distributions" from an LTC are defined as:

"the market value of distributions to the person from the LTC, including loans made to the person from the LTC and payments to which section DC 3B (payments to working owners) does not apply."

171. A pro rata capital reduction, in the case of an LTC, or a pro rata reduction in partnership interests in the case of a partnership, should be regarded as a distribution, but this conclusion is reached more easily with the LTC definition of "distributions". A reduction in a partner's interest is a distribution from a limited partnership under section 39 of the *Limited Partnerships Act 2008*.

172. A non-pro rata reduction in an LTC owner's interest is specifically deemed to be a disposal of the owner's LTC interest, but that is not the case with a reduction in an individual partner's contribution to a limited partnership. A reduction in a partner's contribution may well be a disposal under the general framework of Subpart HG depending on the contractual basis on which the contribution is reduced.

6.5 Working owners

(Refer to pages 34 and 37 of the attached PDF on *QC/Partnership/LTC Comparison*)

173. There is essentially no difference in tax treatment between a working owner in an LTC and a working partner in a partnership.

6.6 Apportionment of imputation credits

(Refer to page 39 of the attached PDF on *QC/Partnership/LTC Comparison*)

174. The imputation credits apportioned to a partner must be in proportion to the partner's share of the income from the partnership. There is no such stipulation for imputation credits allocated to an LTC owner (but this should happen anyway, as all shares in an LTC must have equal rights to distributions).

6.7 Agent of absentee partner

(Refer to page 45 of the attached PDF on *QC/Partnership/LTC Comparison*)

175. A partner in a partnership, or a general partner in a limited partnership, is treated as the agent of an absentee partner, or limited partner, respectively, in relation to the absentee's share of partnership income.

176. There is no such agency provision that applies to LTC owners.

6.8 Anti-avoidance

(Refer to page 36 of the attached PDF) on *QC/Partnership/LTC Comparison*)

177. For both LTCs and partnerships, the Commissioner can re-allocate amounts paid to a relative which the Commissioner considers excessive, if the employment contract is not a genuine contract of employment as described in s. GB 24.

178. Excessive income derived by an LTC owner who is under 20 years old and a relative of another LTC owner can be re-allocated. There is no equivalent rule for a partnership.

179. Under s. GB 50, the market value can be substituted for the actual consideration in relation to an arrangement entered into by a partner that has the purpose or effect of defeating the intent and application of the partnership tax regime. The same rule applies to an LTC in a partnership or a joint venture with another LTC, but there is no equivalent rule that applies to LTCs in general.

6.9 Corporate law differences

(Refer to pages 5 to 8 of the attached PDF on *QC/Partnership/LTC Comparison*)

180. The *Companies Act 1993* applies to an LTC. The *Limited Partnerships Act 2008* applies to a limited partnership, and the *Partnership Act 1908* applies to ordinary partnerships.

7. COMPANIES AND LIMITED PARTNERSHIPS AMENDMENT ACTS 2014

(See also page 9 of the attached PDF on *QC/Partnership/LTC Comparison*)

181. The *Companies Amendment Act 2014* was enacted on 2 July 2014. The *Limited Partnerships Amendment Act 2014* was also enacted on 2 July 2014.

182. Part 2 of the *Companies Amendment Act 2014* inserted requirements for one or more directors to live in New Zealand and other measures. The “essential requirements” in s. 10(d) of the *Companies Act 1993* now require at least one or more directors to:

    (a) Live in New Zealand; or

    (b) Live in an “enforcement country” (currently Australia, under Regulation 12 of the *Companies Act 1993 Regulations 1994* as inserted by s. 4 of the *Companies Act 1993 Amendment Regulations (No 2) 2014*) and be a director of a company that is registered in that enforcement country.

183. An application to register a company must include, under s. 12(2)(b) of the *Companies Act 1993*, in relation to every director of the proposed company:

    (a) His or her full name and date and place of birth; and

    (b) His or her residential address; and

    (c) If the residential address is in an enforcement country, whether the director is a director of a company that is registered (except as the equivalent of an overseas company) in that enforcement country and, if so, the prescribed information.

184. In addition to the above, s. 12(2)(c) requires the company’s ultimate holding company information to be provided.

185. Part 1 of the *Limited Partnerships Amendment Act 2014* inserted requirements for one or more general partners to live in New Zealand and other measures.

186. Section 8(4) of the *Limited Partnerships Act 2008* inserted by s. 5(4) of the *Limited Partnerships Amendment Act 2014* provides that a limited partnership must have 1 or more of the following:

    (a) A general partner who is a natural person who:

        (i) Lives in New Zealand; or

        (ii) Lives in an enforcement country and is a director of a company that is registered (except as the equivalent of an overseas company) in that enforcement country;

    (b) A general partner that is a limited partnership and that has 1 or more general partners who are natural persons who:

        (i) Live in New Zealand; or

        (ii) Live in an enforcement country and are directors of a company that is registered (except as the equivalent of an overseas company) in that enforcement country;

    (c) A general partner that is a partnership governed by the Partnership Act 1908 and that has 1 or more partners who are natural persons who:

        (i) Live in New Zealand; or

        (ii) Live in an enforcement country and are directors of a company that is registered (except as the equivalent of an overseas company) in that enforcement country;

    (d) A general partner that is a company;

    (e) A general partner that is an overseas company registered under the Companies Act 1993 and that has 1 or more directors who are natural persons who:

        (i) Live in New Zealand; or

(ii) Live in an enforcement country and are directors of a company that is registered (except as the equivalent of an overseas company) in that enforcement country.

187. In addition, s. 8(5) of the *Limited Partnerships Act 2008* inserted by s. 5(5) of the *Limited Partnerships Amendment Act 2014* requires every natural person who is a general partner, or who is a director, partner, or general partner of a general partner, to be qualified under s. 19A.

188. Section 19A(1) states that a natural person who is not disqualified by s. 91A(2) is qualified to be appointed as a general partner of a limited partnership. Section 19A(2) states that the following persons are disqualified from being appointed or holding office as a general partner of a limited partnership:

(a) A person who is under 18 years of age;

(b) A person who is an undischarged bankrupt;

(c) A person who is prohibited from being a director or promoter of, or from taking part in the management of, a company under any of the *Companies Act 1955*, the *Companies Act 1993*, the *Limited Partnerships Act 2008*, the *Financial Markets Conduct Act 2013*, the *Takeovers Act 1993*, a notice given under a prescribed foreign country, or a person who is subject to a property order under the *Protection of Personal and Property Rights Act 1988*.

8. INLAND REVENUE QBs ON LTCs AND LIMITED PARTNERSHIPS

189. Inland Revenue Revenue has released a number of "Questions We've Been Asked" ("QBs") in recent years concerning look-through companies ("LTCs") and two QBs concerning partnerships:

(a) QB 11/03 "Income tax – look-through companies and interest deductibility" published in *Tax Information Bulletin* Vol 23, No 10 (December 2011) p.16;

(b) QB 12/08 "Income tax - look-through companies: interest deductibility on funds borrowed to repay shareholder current accounts" published in *Tax Information Bulletin* Vol 24, No 6 (July 2012) p.70;

(c) QB 12/09 "Income tax - look-through companies: interest deductibility where funds are borrowed to make a payment to shareholders to reflect an asset revaluation" published in *Tax Information Bulletin* Vol 24, No 6 (July 2012) p.72;

(d) QB 12/11 "Income tax - look-through companies, rental properties and avoidance" published in *Tax Information Bulletin* Vol 24, No 7 (August 2012) p.110;

(e) QB 14/02 "Income tax – entry of a new partners into a partnership – effect on continuing partners" published in *Tax Information Bulletin* Vol 26, No 5 (June 2014) p.53;

(f) QB 14/11 "Income tax – scenarios on tax avoidance" published in *Tax Information Bulletin* Vol 26, No 11 (December 2014) p.3;

(g) QB 15/01 "Income tax – tax avoidance and debt capitalisation" published in *Tax Information Bulletin* Vol 27, No 3 (April 2015) p.25;

(h) QB 15/11 "Income tax – scenarios on tax avoidance - 2015" published in *Tax Information Bulletin* Vol 27, No 10 (November 2015) p.27;

(i) QB 17/09 "Is there a full or partial disposal when an asset is contributed to a partnership as a capital contribution?" published in *Tax Information Bulletin* Vol 30, No 1 (February 2018) p.10.

190. Please refer to the attached pdf on Relevant Inland Revenue QBs for a discussion on the above publications by Inland Revenue.