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WEEKLY COMMENT: FRIDAY 5 FEBRUARY 2016

1. This week I continue looking at the proposals in *Closely held company tax issues – An officials' issues paper* ("the CHC Issues Paper") released on 8 September 2015. As noted last week, officials have stated that the "changes are intended to included in the next omnibus tax bill, with most of the changes applying from the beginning of the 2017-18 income year". This week I look at the proposals in relation to:

   (a) Transitioning into the LTC regime;

   (b) LTCs and debt remission income;

   (c) Qualifying companies;

   (d) Dividend distributions from close companies;

   (e) Proposals to allow capital gains to be distributed tax-free;

   (f) RWT issues relating to dividends and interest paid to shareholders;

   (g) RWT on dividends between companies;

   (h) Treating a cash and non-cash dividend as a single cash dividend for RWT;

   (i) Allowing mixed PAYE and provisional tax to apply to shareholders' salaries.

Transitioning into the LTC regime

2. When a company becomes a LTC, the owners have income, at the beginning of the first full year that the company is a LTC, equal to their share of the company's untaxed reserves. The tax rate that applies is the company tax rate of 28%.

3. Officials maintain the use of the company tax rate provides an advantage for LTC owners on a higher marginal tax rate and a disadvantage for those on a lower rate. They have proposed that the adjustment formula should be replaced with one that taxes the income that arises at the shareholders' marginal rates.

4. The new formula would treat the retained earnings and imputation credits arising on a notional liquidation as being distributed to the LTC shareholders who would include the income and imputation credits in their income tax returns.

5. If the transitioning company is a qualifying company ("QC"), the new formula would make it clear that income distributed to shareholders will not be taxed to the extent that it is unimputed, consistent with the QC rules. However, there will continue to be a prohibition on losses accumulated in a QC being carried over into a LTC. Losses transferred on conversion during the two-year exemption window will continue to be usable.

6. Officials have also proposed a retrospective technical change to clarify that when an ordinary company or a QC transitions into a LTC, the values of the assets and liabilities deemed to be held by the LTC's owners and in the LTC's accounts should be based on the tax book values immediately before conversion.

LTCs and debt remission income

7. When debt owed by a LTC is remitted, the application of the financial arrangements rules results in debt remission income. This income is attributed to the LTC's shareholders in according to their ownership shares. Similarly, when debt owed by a partnership or a limited partnership is remitted, this results in debt remission income for the partners.

8. Officials have identified that this gives rise to an inappropriate outcome if a LTC's debt that was remitted was advanced by a LTC shareholder (or, in the case of a partnership, the debt remitted was advanced by a partner in the partnership). For example, where there are two 50/50 shareholders in a LTC, and one advances $1m to the LTC which is subsequently remitted, each shareholder would derive $500k of debt remission income under the current rules. However, the shareholder who made the advance has suffered a $1m non-deductible loss and enjoyed only a 50% share of the LTC's corresponding (deductible) loss – i.e. suffered a net loss of $500k.

9. The proposed solution is to turn off the creditor's share of the debt remission income. Under the proposal, only the shareholder who did not make the advance would derive $500k of debt remission income. Officials believe this is appropriate because the shareholder who did not make the advance enjoyed a 50% share of the LTC's $1m loss without an economic cost.

10. Officials have suggested that the above proposal should arguably apply to a creditor partner's share of a partnership's debt remission income.

11. Officials have also proposed a retrospective amendment to clarify that debt remission income arises for LTC owners when they either liquidate or elect to take their company out of the LTC rules. While this was apparently the intention underlying the present rules, which deem a LTC's owners to have disposed of their interests at market value upon liquidation or upon the company ceasing to be a LTC, there are apparently arguments that the present rules do not work as intended. The amendment is designed to "put an end to the debate".

Qualifying companies

12. Officials have discussed two advantages that QCs have over LTCs:

    (a) QCs can provide a potential advantage to shareholders on a marginal tax rate higher than 28% because tax-free distributions of capital gains can be made while the taxable income of the QC can potentially be retained in the company and taxed at the company tax rate of 28%, whereas all income of a LTC is attributed to shareholders and taxed at their marginal tax rates; and

    (b) The sale of shares in a QC will, in most cases, have no tax consequences, whereas a sale of an interest in a LTC can result in depreciation claw-back and taxation of gains on revenue account property, subject to the de minimis thresholds.

13. Officials want to discourage trading in QCs where that trading is driven by their tax advantage, so they have proposed that a QC should lose its QC status upon the sale of the company. The proposal is explained as follows:

    "The sale of the company would be measured by a change in control (that is, a change in shareholding of over 50% in aggregate). We envisage that this would involve applying a shareholder continuity type test to measure if control had been retained by the same group of owners, using as the continuity period the period commencing from the date of enactment of the legislation up to the date of sale of an interest in the QC."

Dividend distributions from close companies

14. Officials have been considering the following issues concerning distributions/dividends made by close companies that are not LTCs:

    (a) Ways to ensure that genuine capital gains made by small businesses do not become taxable merely because there is a transaction involving an associated party;

    (b) Whether resident withholding tax ("RWT") obligations can optionally be removed from small companies, subject to the company or its directors providing guarantees;

    (c) Likewise, whether the requirement to deduct RWT from fully imputed dividends between companies could be optionally removed;

    (d) Ways of streamlining RWT obligations when cash and non-cash dividends are paid concurrently; and

    (e) Whether small businesses could be given the option of treating shareholder salaries as subject to a combination of PAYE and provisional tax.

Proposals to allow capital gains to be distributed tax-free

15. Capital gains made by a company during its existence can be distributed tax-free when it is liquidated. However, this does not include "tainted" capital gains made from transactions with associated persons. Apparently the rule was introduced in the 1980s to prevent an asset being transferred around a group of companies for the purpose of creating additional capital reserves that can be distributed tax-free. Officials' view is that the restriction extends beyond its intended ambit. Two examples are provided to illustrate the problem.

16. The first example illustrates the problem when a company sells an asset to an associated person who is not a corporate:

    (a) Two brothers are equal shareholders in a company that bought and owns 2 farms;

    (b) Following an increase in value of the farms, one of the farms is sold at the higher value to one of the brothers, who pays for it by selling his half-share in the company to the other brother for the same price;

    (c) The gain realised by the company cannot be distributed tax-free upon liquidation because it was made through a sale to an associated person.

17. Officials have proposed that in this situation, the tainting rules should not apply when the associated person is not a corporate. The amendment would be restricted to companies meeting the current definition of "close company" – i.e. a company that has 5 or fewer natural persons the total of whose voting interests in the company is more than 50% (treating all associated natural persons as a single person).

18. Officials recognise that the restriction could be too broad even where the transfer is between two associated companies, such as when there is a development phase and shares or assets are sold to another entity in which the existing owners retain an interest, whereas the restriction would not apply if the existing owners had no ownership interest in the new entity. However, they have stated that they are reluctant to propose eliminating the tainting rules for inter-corporate transfers given the scope for inflating gains.

19. The second example illustrates the problem when an intercompany transfer is followed by a sale to an unrelated third party:
    (a) An asset acquired by a company in a group is sold to another company in the same group at a higher price;
    (b) Following that, the second company on-sells the asset to an unrelated third person for a still higher price;
    (c) The gain realised by the first company is a tainted capital gain, whereas the gain realised by the second company on the price differential is not a tainted capital gain and can be distributed tax-free upon liquidation of the second company.
20. Officials have proposed that in this situation, where there is a group of companies and one of the companies sells an asset to an unrelated third party, the extent to which the capital profit on sale would qualify for a tax-free distribution on liquidation would be determined with reference to the original cost of the asset, ignoring any tainted gains arising from the previous intra-group sales of the asset.
21. There would be no limit on the type of companies to which this second proposal could apply.

RWT issues relating to dividends and interest paid to shareholders

22. The RWT rate for dividends is 33%, which means that "top-up" RWT of 5% must be deducted from even fully imputed dividends. Interest paid to associated persons must have RWT deducted at the shareholder's marginal rate. Officials have discussed the following issues regarding the requirement to deduct RWT from dividends and from interest paid to shareholders:
    (a) RWT is due the month after the dividend is "paid" – i.e. usually the month after year-end, but many companies do not determine the quantum of the dividend until after that time (although not mentioned specifically by officials, the same issue applies to interest paid to shareholders, which is typically determined after year-end, but is treated as accrued and deducted for tax in the financial statements for the year);
    (b) Section RD 36 allows a dividend to be used to retrospectively reduce or eliminate a debit balance in a shareholder-employee's current account on the later of the first day of the income year or the date the debit balance arose – however, the dividend cannot be retrospectively applied for the purposes of this section if any RWT has been deducted from the dividend, therefore, the current discrepancy between the company tax rate and the RWT rate means that s. RD 36 cannot apply to dividends;
    (c) Officials have noted in relation to interest paid to shareholders only that "if RWT on this interest did not need to be accounted for there would seemingly be compliance savings for the taxpayer".
23. Allowing closely held companies the option of electing not to deduct RWT from dividends and possibly interest has been suggested as a possible solution, providing that directors guarantee the payment of the RWT if the shareholders fail to do so. However, officials are reluctant to implement this as a one-off solution because the estimated fiscal cost of a potentially permanent deferral for taxpayers who had RWT deducted in the current year but would pay the tax as terminal tax next year coupled with a higher potential for non-compliance is seen as being too high.
24. Any solution to this problem has been postponed to be considered in the wider context of the work being undertaken to streamline business tax processes. Feedback has been requested on current practice in paying RWT on dividends and interest paid to shareholders.

RWT on dividends between companies

25. Officials have proposed eliminating RWT from fully imputed dividends paid to other companies. They have recognised that the requirement to have top-up RWT of 5% deducted when the receiving company is taxed on the dividend at the company tax rate of 28% adds unnecessary compliance and administration costs.

Treating a combined cash and non-cash dividend as a single cash dividend for RWT

26. Sections RE 13 and RE 14 provide the formulae for use in calculating the RWT to be deducted from cash and non-cash dividends respectively:

    (a) In the case of a fully imputed cash dividend, the formula in s. RE 13 results in a top-up tax of 5% because the RWT can be deducted from the cash dividend;

    (b) In the case of a fully imputed non-cash dividend such as a taxable bonus issue, the formula in s. RE 14 results in a top-up tax of more than 5% because the RWT cannot be deducted from the dividend, therefore, it must be paid as an additional separate amount, increasing the amount of the total dividend (often referred to as a "gross up") and, hence, the RWT.

27. Officials have noted that when a fully imputed combined cash and non-cash dividend is paid, the combination of the above formulae result in top-up tax of more than 5%, which is not appropriate if the total RWT is able to be deducted from the cash portion. They have proposed providing the option of combining the cash and non-cash dividend payments as a single cash payment if the cash dividend alone is sufficient to cover the total RWT.

28. A legislative amendment would be required to allow the two dividends to be treated as a single dividend. It would apply only when the cash dividend was sufficient to cover the RWT for both dividends. The formula in s. RE 13 would be amended so that the non-cash portion is included as if it were a cash portion and s. RE 14 would not apply to the non-cash portion. There would be no limit on the type of companies to which this could apply.

Allowing mixed PAYE and provisional tax to apply to shareholders' salaries

29. Currently shareholder-employees who meet the requirements of s. RD 3 can choose to treat their income from the company as not subject to PAYE. This treatment is "all or nothing" – i.e. the whole of the shareholder-employee's salary is subject to PAYE or not subject to PAYE at all. Officials are of the view that a mixed approach should be permitted.

30. A combination of PAYE on some payments and no PAYE on others is an option that has been proposed for shareholder-employees of close companies. This would be available when a base salary is provided, which would be subject to PAYE under the proposal, but a year-end "top-up" would be subject to provisional tax. Officials have stated that if such an approach is adopted, it should be applied consistently from year to year so that the shareholder-employee is not able to swap in and out of the provisional tax regime. This proposal would apply to QCs as well as other closely held companies.

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