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WEEKLY COMMENT: FRIDAY 29 SEPTEMBER 2017

1. The *Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017* ("the Closely Held Companies Act") received the Royal assent on 30 March 2017. There are a number of changes affecting various parts of the *Income Tax Act 2007* and the *Goods and Services Tax Act 1985*. Over the next few weeks, I look at the changes affecting look-through companies ("LTCs"), qualifying companies, and other closely held companies.

2. This week and next week I look at the changes to the definition of a "look-through company". In the following weeks, I look at the other changes affecting LTCs, the qualifying companies continuity of ownership requirement, and other changes affecting closely held companies generally.

Definition of "look-through company"

3. There is a new hugely expanded definition of "look-through company" in s. YA 1 of the *Income Tax Act 2007*, which comes into force on 1 April 2017, under s. 2(33) of the Closely Held Companies Act. The *changes in the definition below are in highlighted in italics*.

4. A "**look-through company**" ("LTC") is defined as meaning an entity:

   (a) 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; and

   (b) That, treating the entity as a company for the purposes of this definition, is resident in New Zealand under section YD 2; and

   (c) That is not treated under, or for the purposes of, a double tax agreement as not resident in New Zealand; and

   (d) For which there are 5 or fewer **look-through counted owners**, treating look-through counted owners who are relatives, ignoring any later death or dissolution of marriage, union, or relationship, as 1 person; and

   (e) For which all owners have only **look-through interests**; and

   (eb) For which an owner that is a trustee of a trust does not make a distribution to a company that is directly or indirectly a beneficiary of the trust; and

   (ec) For which no owner is a tax charity, unless the tax charity is a ***grandparented charity*** *for the entity (meaning, for the entity, a charity that, before 3 May 2016 is an owner of the entity or has entered into an arrangement to become an owner of the entity); and*

(ed) For which an owner that is a trustee of a trust does not make a distribution of income to a tax charity that is a beneficiary of the trust, unless the tax charity has no control or influence in relation to the operation of the entity and no control or influence in relation to the distributions of the trust; and

(ee) For which no owner is a Maori authority, unless the Maori authority is a ***grandparented Maori authority*** *for the entity (meaning, for the entity, a Maori authority that, before 3 May 2016 is an owner of the entity, or has entered into an arrangement to become an owner of the entity, or is a beneficiary of a trust that is an owner of the entity); and*

(ef) For which an owner that is a trustee of a trust does not make a distribution to a Maori authority that is directly or indirectly a beneficiary of the trust, unless the Maori authority is a grandparented Maori authority for the entity; and

(eg) That, treating the entity as a company for the purposes of this definition, in the case where more than 50% of the total ownership interests in the entity are held by ***foreign LTC holders*** *(meaning a non-resident, or a trustee of a trust, if the trust has a non-resident settlor, but only to the extent of the proportion of the trust's ownership interests that is equal to the proportion of settlements, by value, made by non-resident settlors, ignoring settlements arising from services provided for less than market value), the entity has a foreign-sourced amount for the income year that is not more than—*

> *(i) $10,000; or*
>
> *(ii) If 20% of the entity's gross income for the year ("the 20% gross amount") is greater than $10,000, the 20% gross amount; and*

(f) That is not a flat-owning company; and

(g) For which an election under section HB 13 (Valid elections) has been received by the Commissioner.

5. There is a new expanded definition of "**look-through counted owner**" in s. YA 1, which also comes into force on 1 April 2017. Again, *the changes in the definition are highlighted in italics*. A "look-through counted owner" is defined as meaning, for an entity, a person who:

(a) Is a natural person that—

> (i) Is not a trustee; and
>
> (ii) Has a look-through interest for the entity;

(b) Is a natural person who has derived, as beneficiary income of a trust, income that arose from a direct or indirect beneficial interest in a look-through interest for the entity for the current income year or 1 of the last 3 income years;

(bb) Is a natural person who:

> *(i) On or after the first day of the 2017–18 income year, receives a distribution ("the distribution") from a trust, other than a distribution sourced from income derived by the trust before the 2017–18 income year; and*
>
> *(ii) The distribution is received in the current income year, or 1 of the last 3 income years if the relevant year is after the 2016–17 income year; and*
>
> *(iii) The trust has a direct or indirect beneficial interest in a look-through interest for the entity in the current income year, or 1 of the last 3 income years if the relevant year is after the 2016–17 income year:*

(c) Is a trustee of a trust that:

(i) Has a look-through interest for the entity or has a direct or indirect beneficial interest in a look-through interest for the entity, treating co-trustees as 1 person; and

(ii) Has no beneficiary that is a look-through counted owner;

(d) Is a natural person that has a voting interest or a market value interest in relation to a company that has derived, as beneficiary income from a trust, income that arose from a direct or indirect beneficial interest in a look-through interest for the entity for the current income year or 1 of the last 3 income years.

6. There is a new expanded definition of "**look-through interest**" in s. YA 1, which also comes into force on 1 April 2017. Again, *the changes in the definition are highlighted in italics*. A "look-through interest" is defined as meaning a person's shares in an entity, or in a look-through company ("LTC") treating the look-through company as a company for the purposes of this definition, if:

(a) *Repealed;*

(b) Every other shareholder has the same rights, proportionally, as the person in relation to a distribution by the entity or LTC; and

(c) The entity or LTC has only shareholders that are natural persons, or corporate trustees.

LTC definition change 1: A trustee owner of a LTC cannot make a distribution to a company that is directly or indirectly a beneficiary of the trust

7. Under the rules pre-1 April 2017, direct ownership by companies, other than other LTCs, is expressly prohibited, but a trust that owns a LTC interest can have a corporate beneficiary. The trust is looked through and the shareholders of the corporate beneficiary are counted if it receives any beneficiary income. Officials are concerned that this allows widely held non-LTC corporates with a way to circumvent the prohibition on direct ownership.

8. The definition of "look-through company" has been amended, with effect from 1 April 2017, to expressly prohibit trusts which own LTCs from making distributions to corporate beneficiaries either directly or indirectly. This approach allows for grandparenting of current structures involving corporate beneficiaries, by not expressly prohibiting LTC owning trusts from having corporate beneficiaries (so long as the trust does not make further distributions to the company).

9. An example is provided on page 35 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 ("the TIB Item"), 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.

Losing LTC status: transitional rule

10. 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".

11. It is stated on page 48 of *Tax Information Bulletin* Vol. 23, No. 1, February 2011 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."

12. The continued operation of this rule is confirmed on page 31 of the TIB item, 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."

13. 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.

14. 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.

15. 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.

16. It is stated on page 37 of the TIB Item 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.

17. An example is provided on page 37 of the TIB Item as follows:

    "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."

Arun David, Director,

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