



## WEEKLY COMMENT: WEDNESDAY 1 AUGUST 2012

1. This week I continue looking at the New Zealand tax treatment of US LLCs.

### **New Zealand tax treatment of US LLCs: Part 2**

2. I look at:

- The foreign tax credit rule changes affecting investments in US LLCs and the implications for company and non-company New Zealand shareholders.
- The recent changes to the CFC “same country income exemptions” in the *Taxation (International Investment and Remedial Matters) Act 2012* are explained in *Tax Information Bulletin* Vol 24 No 6 July 2012 in terms of the New Zealand tax treatment of US LLCs as CFCs.
- The application of the NZ/US tax treaty.

### **Foreign tax credit implications**

3. As part of the 2006 amendments, section LC 4(1) of the Income Tax Act 2004 was amended to allow a person who has attributed CFC income a tax credit for foreign tax payable directly by the person in respect of the CFC’s income.
4. The IRD explained the 2006 tax credit rule changes in its website explanation as follows (all section references are to the Income Tax 2004):

“However, there was uncertainty in the rules about whether New Zealand members of a foreign hybrid entity could claim a foreign tax credit against their New Zealand income tax liabilities under the previous tax credit provisions in the Income Tax Act 2004. That uncertainty arose because, under the CFC credit provision in section LB 4, a credit was given only for foreign tax paid by the CFC. Yet a foreign hybrid, that is a CFC, does not actually pay the foreign tax because the tax is imposed on its members.

The Income Tax Act 2004 has been amended as follows:...

- Section LC 4 enables shareholders with investments in foreign hybrids that are CFCs or branch equivalent FIFs to receive tax credits for the foreign tax paid by the shareholder....
- When attributing income under the accounting profits method in relation to a FIF, section EX 42 allows foreign tax paid by the New Zealand shareholder on income earned by the foreign hybrid to be taken into account. This effectively reduces the amount of attributed income.

- When attributing income under the comparative value method in relation to a FIF, section EX 44 allows foreign tax paid by the New Zealand shareholder on income earned by the foreign hybrid to be included in the definition of costs. This effectively reduces the amount of attributed income.
  - When attributing income under the deemed rate of return method in relation to a FIF, section EX 45 allows foreign tax paid by the New Zealand shareholder on income earned by the foreign hybrid to be included in the definition of costs. This effectively reduces the amount of attributed income.”
5. The section in the Income Tax Act 2007 that corresponds to section LC 4(1) in the Income Tax Act 2004 is section LK 1(1), which allows a person a tax credit for:
    - (a) Income tax paid by the CFC from which the income is derived;
    - (b) Income tax withheld and paid on behalf of the CFC;
    - (c) Foreign income tax paid by the CFC; and
    - (d) Foreign income tax paid by the person under foreign laws that are the equivalent of the international tax rules.
  6. Although the wording of section LK 1(1) does not refer specifically to “(foreign) tax paid by the person in respect of the attributed CFC income”, it would appear that no law change was intended, and the flow-through tax treatment afforded a US LLC falls within the requirements of section LK 1(1). This is borne out by the IRD explanation on page 42 of *Tax Information Bulletin* Part II Vol 21 No 8 October/November 2009:

“Subpart LK makes provision for tax credits relating to attributed CFC income. A person who has attributed CFC income for an income year is *allowed a tax credit for income tax and foreign income tax paid in relation to that income by the person or the CFC...* The tax credit rules for CFCs in subpart LK are applied to branch equivalent FIFs by section EX 50(8) and (9).” (emphasis added)
  7. For a New Zealand company shareholder in a US LLC that is a CFC, if the active income exemption is not available, US tax paid should be available as a tax credit against NZ tax payable on attributed CFC income. Distributions from the LLC will be treated as dividends, which will be exempt under the foreign dividend exemption in section CW 9 (unless the distributions are in relation to fixed-rate foreign equity or deductible foreign equity – refer to paragraphs 17 – 19 of last week’s *Weekly Comment*).
  8. For a New Zealand non-company shareholder in a US LLC that is a CFC, the position is more complicated. If the active income exemption is not available, US tax paid should be available as a tax credit, under section LK 1(1), against NZ tax payable on attributed CFC income. However, distributions from the LLC will be treated as dividends, which will not be exempt under the foreign dividend exemption in section CW 9. The New Zealand shareholder will have to make use of a BETA account in order to avoid double taxation.
  9. For a New Zealand company shareholder in a US LLC that is a FIF:
    - (a) For income years beginning on or after 1 July 2011, US tax paid will not be able to be credited unless the Attributed FIF Income (AFI) method is used. The AFI method is only available if the interest in the LLC is at least 10%.
    - (b) For earlier income years, beginning on or before 30 June 2011, the alternative of using the Comparative Value (CV) method was available for FIF interests of at least 10%, and

foreign tax paid by the shareholder could be deducted as part of the CV formula. From income years beginning on or after 1 July 2011 companies cannot use the CV method, except to the extent that shares in the LLC are “non-ordinary shares”.

10. For a New Zealand non-company shareholder in a US LLC that is a FIF the position depends on whether or not the shareholder is either a natural person or a family trust:
  - (a) Natural persons and family trusts may use the CV method and are therefore able to deduct US tax paid on income from a US LLC.
  - (b) Natural persons and family trusts with a shareholding of at least 10% in a US LLC may use the AFI method and claim US tax paid as a tax credit against New Zealand tax payable, if the active income exemption is not available (but dividends will be taxable – subject to the dividend reduction formula in section CD 18).
  - (c) Other (non-family) trusts may not use the CV method. If the shareholding in a US LLC is at least 10%, the AFI method may be used with the same consequences as for natural persons and family trusts set out in sub-paragraph (b) above.
  - (d) US tax paid by non-company shareholders in respect of a US LLC’s income may not be claimed as a tax credit under any other FIF methods.

#### **CFC rules same country income exemptions**

11. When a CFC derives interest, royalties or rent from an “associated non-attributing active CFC”, the income can be ignored if certain requirements are met. Before the enactment of the *Taxation (International Investment and Remedial Matters) Act 2012* both the paying and the receiving CFC had to be subject to tax in the same jurisdiction. In addition, income that a CFC receives from its country of residence in the form of rent (from real property) or income from telecommunications services could be ignored if the CFC was subject to tax in its country of residence.
12. These exemptions have been widened by changes enacted in the *Taxation (International Investment and Remedial Matters) Act 2012* with retrospective effect from 1 July 2009. The changes in the form of a revised definition of “associated non-attributing active CFC” and a new definition of “taxed CFC connection” allow some companies, which are not recognised for tax purposes in the country they operate in, to nevertheless be treated as resident in that country.
13. The explanation of the changes in pages 45 – 47 of *Tax Information Bulletin* Vol 24 No 6 July 2012 refers specifically to US LLCs:

“Some entities that New Zealand considers to be foreign companies are not treated as taxable entities in the country in which they are registered or organized. For example, a United States Limited Liability Company (LLC) such as a so-called “Delaware company” is often considered by the United States to be analogous to a partnership for tax purposes. In that case, it is not liable to tax in that country (though its shareholders may be) and the foreign company is not able to take advantage of the same country exemptions.

#### *When the current position is logical*

Excluding entities such as LLCs from the same country exemptions is often the correct result. For example, if an LLC owns an ordinary active company in the same country, and is able to extract the profit from that active company in the form of an interest payment, there may be very little foreign tax imposed on the income of the LLC, its shareholders, or

the active company. In that case, it would not be appropriate to exempt the income from New Zealand tax.

*When the exemptions should apply even though there is no liability to tax*

However, there are cases when excluding entities such as LLCs from the same country exemptions is unnecessary and even counterproductive. In particular, if the LLC is wholly owned by another company in the same country, and that other company is liable for tax on the LLC's income, the outcome should be similar to the case in which all of the companies are liable to tax in that country. In those cases, normal tax is paid on the active income of the group in the foreign country and New Zealand should be prepared to exempt the income here."

14. Under the new "taxed CFC connection" rule, the same country income exemptions (for interest, royalties and rent) will apply to a US LLC if the following requirements are met:
- (a) First, that the LLC is a resident of the US under section YD 3;
  - (b) Secondly, that the LLC is not treated as a dual-resident; and
  - (c) Thirdly, that the LLC does not have a fixed establishment or a permanent establishment outside the US.
  - (d) Fourthly, the LLC is wholly owned, under the laws of New Zealand and the US, either directly or through a chain of wholly owned companies, by another CFC that meets the conditions for residence in the previous section; and
  - (e) Fifthly, the other CFC is liable to tax on the income of the LLC in the US by reason of its domicile, residence, place of incorporation or centre of management, in the same period as the LLC would be liable if it was an ordinary company liable to tax in the US.
15. Most LLCs will probably not satisfy the requirements for this exemption to apply. In a number of cases, the main reason for having a US LLC is to allow flow-through tax treatment to different owners.

### **Impact of the double tax treaty with the US**

16. The Articles of the Double Tax Agreement with the US will apply to a New Zealand resident shareholder in a "tax flow-through" US LLC as if the New Zealand resident was directly entitled to the LLC's income. Article 1, paragraph 6 states that:

"An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident."



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