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WEEKLY COMMENT: FRIDAY 13 OCTOBER 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.
2. This week I look at some remaining changes affecting look-through companies ("LTCs"): the change allowing different voting rights, the voting rights changes, the changed calculation of LTC entry tax and the changed deduction limitation rule. Next week I will complete looking at the changes affecting LTCs by looking at the new rules on self-remission of LTC debts.

Voting rights changes

3. The requirement that LTCs could have only one class of share has been relaxed through amending the definition of "look through interest". The amendment allows a LTC to have shares that carry different voting rights provided that all shares still have the same rights to distributions.
4. The amendment applies to the 2017-18 and later income years.

LTC entry tax changes

5. 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.
6. 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.
7. 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.

8. 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) × effective interest

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

   dividends – assessable income – exit exemption.

10. In the formula for calculating untaxed reserves, "dividends" is the cash that would be dividends for tax purposes, that is distributed without any imputation credits attached to the company's shareholders immediately before it either became a LTC or amalgamated with a LTC if:

    (a) Immediately before it became a LTC or amalgamated with a LTC it disposed of all its property, other than cash, to an unrelated person at market value, for cash; and

    (b) It met all of its liabilities at market value, excluding income tax payable, through disposing of the property or meeting the liabilities; and

    (c) It was liquidated.

11. In the formula for calculating untaxed reserves, "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.

12. 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."

13. 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.

14. Finally in the formula for calculating untaxed reserves, " 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).

15. "Reserves imputation credit" is the total amount of credits in the company's imputation credit account, 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.

16. 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 imputation credit] × effective interest.

17. "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).

18. The 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.

19. 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.

20. The dividend which results from the entry tax formula is disregarded for the purposes of the benchmark dividend rules in s. OB 61. The level of imputation attaching to the entry tax deemed dividend does not require a benchmark dividend ratio change declaration as the company is not an imputation credit account (ICA) company as defined in s. OB 1 at the time that the dividend arises.

21. There is also no RWT deductible from the dividend. The newly inserted s. RE 2(5)(gb) provides that an amount treated as a dividend under s. CB 32C is excluded from a dividend and is, therefore, not resident passive income under s. RE 2.

22. A detailed example is provided on page 40 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 ("the TIB Item") as follows:

    "X Co is an ordinary company which converts to a LTC. It has two shareholders: Amy, who has 40 % of the shares, and Ben, who holds 60 % of the shares.

    $500,000 of equity was put into X Co, which X Co used to purchase a $500,000 house it acquired with the intention of resale. The house is now worth $700,000. X Co also has $72,000 of retained earnings and $28,000 of imputation credits from rent received from the house.

    Untaxed reserves are calculated using the formula: (Dividends – assessable income – exit exemption).

    The dividends are the amounts that would be dividends if X Co sold its $700,000 house, then liquidated. If X Co liquidated it would have $272,000 of dividends, being the $700,000 cash from the property, the $72,000 of retained earnings, minus the subscribed capital of $500,000.

    The assessable income of X Co would be $200,000, being the total assessable income that X Co received from the sale of the house (as it was held on revenue account).

The exit exemption would not apply as X Co has not previously been a LTC.

Therefore, the untaxed reserves are $72,000.

The "reserves imputation credit" in the entry tax formula is $28,000.

As a result, the entry tax calculations are as follows:

- Amy's gross dividend would be: (72,000 + 28,000) × 0.4 = $40,000, which would include 40% of the imputation credits – i.e. 40% of $28,000 = $11,200; and
- Ben's gross dividend would be: (72,000 + 28,000) × 0.6 = $60,000, which would include 60% of the imputation credits – 1.e. 60% of $28,000 = $16,800.

Deduction limitation rule

23. 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) A LTC in a partnership that includes another LTC; or

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

24. This means that there is no longer any limitation on deductions for a 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 ss. HB 12(2) and HB 12(3).

25. Officials are of the view that this rule results in compliance costs that appear to outweigh the benefits provided from the operation of the rule. However, partnerships and joint ventures of LTCs are in many respects an alternative to limited partnerships where a deduction limitation rule is appropriate. They can also be potentially widely held vehicles.

26. The formula determining the "owner's basis" in s. HB 11 will otherwise be unchanged. However, it is noted on page 41 of the TIB item that officials are continuing to explore options for simplifying and clarifying the formula.

27. 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 a LTC.

28. 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.

29. 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."

30. 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."

31. 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.

32. 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.

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