



KPMG
10 Customhouse Quay
P.O. Box 996
Wellington
New Zealand

Telephone +64 (4) 816 4500
Fax +64 (4) 816 4600
Internet www.kpmg.com/nz

Deputy Commissioner
Policy and Strategy Division
Inland Revenue
P O Box 2198
Wellington 6140

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Dear Sir

KPMG submission - closely held company taxation issues

KPMG is pleased to make a submission on the closely held company taxation issues paper (the “Issues Paper”).

General comments

We strongly support the review of the tax rules for closely held companies, in particular the Look Through Company (“LTC”) rules, a number of features of which have been a barrier to effective use of those rules. We support the proposals to make those rules more user friendly, but have concerns about the proposals to tighten some of the entry requirements. We comment on the specific proposals in our detailed submission, which is attached as an appendix.

While we are supportive of proposals to simplify and reduce compliance costs with paying dividends from closely held companies, we are disappointed with the changes that have been proposed.

We understood one of the aims of the review was to bridge the gap between LTCs (and qualifying companies) and other closely held companies. We note that the LTC (and qualifying company) rules, among other things, allow capital gains to be accessed tax-free prior to liquidation. It is surprising to see Officials refer to the ability for shareholders to receive capital gains tax-free on liquidation, in the normal company context, as being a “distortion” (we refer paragraph 2.24 of the Issues Paper).

We believe this to be a desirable feature, not an unwanted one, if the aim of imputation is to integrate the personal and company tax bases. The distortion is the reverse, that capital gains (which under current tax policy settings are explicitly not taxable in New Zealand) are taxable if distributed by a company other than on liquidation. Therefore, any mechanism to remove this “distortion” is supported.

The close company proposals in the issues paper are limited to removing tainting of related party capital gains and relaxation of RWT requirements in some circumstances. While these are useful changes, and supported, the close company tax review has taken a significant amount of time. A number of taxpayers would have been awaiting the outcome of that review, before



deciding which tax structure to transition to, or adopt. We do not believe the choices are much clearer following the release of the Issues Paper.

Further information

Please do not hesitate to contact us, John Cantin on 04 816 4518 or Darshana Elwela on 09 367 5940 if you would like to discuss this submission in greater detail.

Yours sincerely

John Cantin
Partner

Darshana Elwela
National Tax Director

Appendix – KPMG’s detailed submission on the Issues Paper

Chapter 3 – LTC entry criteria

One class of share

We support the proposal to allow an LTC to have more than one class of share if the rights to distributions of the company’s net income and assets are the same for all members of the class.

Review of shareholder requirements

We consider the proposals to make the LTC entry criteria more restrictive are not warranted. In our view, the rules to qualify as shareholders in LTCs need to be made simpler, not more complicated, to make the regime more accessible.

Trusts

The Issues Paper proposes increasing the period over which beneficiaries of trust shareholders in an LTC must be tested to determine if they are counted owners, from 3 to 6 years. The stated concern is beneficiary “rotation”.

However, it is not clear to us that the current 3 year measurement period is being circumvented in practice. A 6 year measurement period will impose additional costs on LTCs and trustees from having to monitor trust distributions, to ensure LTC status is not inadvertently lost. This will create inflexibility for trustees. In most family trust scenarios, we expect a change of beneficiaries will be due to changes in family circumstance (e.g. relationship splits, births and deaths of family members), and not tax driven.

We are similarly concerned about the proposal to expand the counted distributions definition to include trustee income and corpus, as well as beneficiary income. We see no need to expand the definition in this way. There is no policy rationale for why a payment of capital by the trust, to its beneficiaries, should affect whether a company, that the trust is a shareholder of, loses their LTC status.

The counted distribution should be limited to a distribution of the LTC’s income, as this is the mischief the rule should be aimed at. Where the trust is distributing its capital (corpus) or non-LTC income (either as trustee of beneficiary income), the recipients of these amounts should not be treated as counted owners. (We note this would require amending the current rule that includes all beneficiary income as counted distributions.)

The Issues Paper proposes that, in the event that not all income is distributed as beneficiary income in the relevant period, the trustee should be treated as a single counted owner. We support this proposal, subject to our comments above.

Corporate beneficiaries

It is not clear to us that the proposal to revoke LTC status if a company has trust shareholders with corporate beneficiaries is necessary. As the Issues Paper notes, LTC status is already revoked if the corporate beneficiary is widely-held (meaning it is only other close companies that can be beneficiaries, and their shareholders are in turn counted owners). While we

recognise the suggestion is to limit the rule to corporate beneficiaries to which any distributions are made by the trust, this change seems unnecessary for the potential revenue at risk. (Alternatively, our suggestion above to limit the rule to distributions of LTC income would appropriately mitigate the risk.)

Charities and Maori authorities

The proposal to omit charities and Maori authorities from being direct or indirect LTC shareholders seems short-sighted. We are concerned that the wider implications have not been thought through.

Most, if not all, family trusts will have a charity as a beneficiary (usually as the residual or final beneficiary after the trust property is distributed to the various family members).

Limiting the amount that can be distributed to charities to 10 percent of the trust's share of the net income from the LTC each year does not adequately deal with this issue.

Firstly, the 10 percent threshold is arbitrary, and may require changes to trust deeds where more than 10 percent is distributable to charities currently. Secondly, LTC status would be automatically revoked when the only remaining beneficiary of the trust is the charity. This may be outside the control of the other LTC shareholders. If the stated intention is not to discourage charitable giving, the proposed rule should not proceed. Thirdly, it is not clear to us what revenue is actually at risk if an LTC has a trust shareholder with a beneficiary that is a charitable organisation. The charity would receive the same tax outcome, as if investing directly.

Similarly, we see no benefit to excluding Maori authorities from being shareholders in an LTC. The LTC mechanism allows Maori authorities (and charities) "flow through" tax treatment that they would otherwise receive under a partnership (or limited partnership) structure, or investing directly. There is, therefore, no tax advantage to be had from using an LTC and forcing Maori authorities (and charities) to adopt an arguably more complicated tax structure is not sensible.

If there are genuine concerns that the LTC rules are being used to generate unintended tax outcomes, for trusts or other shareholders, the Commissioner has at her discretion the general anti-avoidance rule to combat such arrangements. We believe this is a more appropriate tool to deal with cases, which are likely to be at the margin.

At a minimum, if the changes proceed, there should be transitional rules to safeguard the status of existing LTCs, to the extent they are compliant with the current shareholding requirements.

These structures should either be "grandfathered" or a transitional period (say 2 years) allowed to transition to a more appropriate tax structure with no adverse tax consequences (similar to the changeover from the loss attributing qualifying regime).

Chapter 4 – Foreign income and non-resident ownership

The Issues Paper proposes that, when more than 50% of shareholders in an LTC are non-residents, the LTC's annual foreign income will be restricted to the greater of \$10,000 or 20 percent of the LTC's gross income.

It is unclear why the use of LTCs to derive foreign income, e.g. as part of a conduit arrangement involving non-resident shareholders, is problematic, from a New Zealand tax perspective. New Zealand's current tax policy settings are not to tax the non-NZ sourced income of non-NZ tax residents. (We note the potential BEPS concerns, but that should be considered as part of that wider project, not the close company review.) The LTC rules, to the extent used by non-residents to derive non-NZ income is consistent with those policy settings.

If there are reputational concerns (e.g. that NZ may be seen as a "light touch" or the LTC rules could be viewed as a harmful tax regime by our trading and investment partners) this should be addressed by an appropriate reporting and disclosure regime, not by arbitrarily limiting entry into the rules, which can have unintended consequences.

The Issues Paper notes:

- Hybrid entities is a BEPS focus. Any issues with hybrid tax mismatches should rightly be dealt with as part of those changes, and not the closely held company tax review.
- There is little evidence of the LTC regime being used to earn foreign income or offset foreign losses. Of the more than 46,000 registered LTCs in 2013, less than 300 had foreign income and less than 25 had foreign losses. This is therefore not an issue of any scale to warrant a legislative response.
- The revenue risk is low from LTCs being used as conduit entities by non-resident shareholders, due to application of New Zealand's thin capitalisation rules and the need for nexus with income to deduct interest. So, again, it is unclear to us what the problem actually is. In contrast, the practical implications of loss of LTC status if shareholders move overseas will be very real.

If this proposal proceeds, the foreign income threshold needs to be raised to a more commercial level. We suggest that the foreign income component of an LTC be raised to a maximum of 50 percent of the LTC's gross income. The proposed \$10,000 income threshold should be removed altogether.

Use of LTCs to invest offshore by New Zealanders

We note that the foreign income concerns for New Zealand shareholders is that they would be entitled to receive foreign tax credits. The justification for limiting the ability to use such credits is concern that foreign investment would be preferred to New Zealand investment.

Given that the LTC rules are targeted at closely-held companies, we would be surprised if that were the case for such companies. A closely-held company is likely to make a foreign investment if:

- There is no opportunity in New Zealand (or, put another way, it considers it has exhausted its New Zealand opportunities); or
- Family members are located offshore.

We also note the Government's Business Growth Agenda and specifically its export growth agenda, which considers that investment outside New Zealand is required. A disincentive to invest offshore should therefore not be implemented.

Chapter 5 – Deduction limitation rule

We strongly support the removal of the deduction limitation rule for LTCs. The current rule is a major impediment to use of the LTC regime by a wider range of taxpayers, due to its complexity (e.g. the need to calculate and track owner's basis and apply the rule to every owner).

We also support the proposal to allow accumulated losses, due to the application of the deduction limitation rule, to be fully utilised in the 2017-18 income year.

When excess deductions arise that might justify restrictions

It is proposed that the deduction limitation rule would continue to apply where there is a partnership of LTCs (to replicate the effect of the deduction limitation restrictions under the limited partnership rules).

While we can understand Officials' desire for consistency, this does raise the question of why limited partners in limited partnerships should have their tax deductions restricted to capital at risk. In our view, "money at risk" is the appropriate mechanism to limit losses where there may be concerns regarding the validity of deductions.

In terms of practical application of the rule to partnerships of LTCs, we concur that basing the application of the test on the number of combined owners will be problematic as each LTC in the partnership may not have information on the others' shareholders (and therefore the total number of counted owners). A better option, in our view, would be to limit the number of LTCs allowed, in a partnership, without application of the deduction limitation rule to the LTCs. Based on the "distribution of LTC owner" statistics in the Issues Paper, the vast majority of LTCs have less than 2 owners. Therefore, by extrapolation, a partnership of, say, 3 or fewer LTCs could be allowed without the deduction limitation rule applying.

Arrangements involving partners

The Issues Paper asks for feedback on the application of the market value requirement in section GB 50 to LTCs. We support the extension of the rule in so far as its application will be rare in practice (we would expect this to be the case as section GB 50 only applies when the arrangement has a purpose or effect of defeating the intent and application of the rules). It would be useful to have examples of when this rule could be expected to apply, to provide clarity. The specific example included in the Issues Paper is, in our view, unhelpful. It is not clear why that particular arrangement should be of concern.

Partial versus full look through treatment

The need for specific anti-avoidance rules would also be reduced if the position on the transparency of an LTC (and other tax transparent entities) was fully resolved.

A LTC (and limited partnership) is transparent for tax purposes, i.e. the shareholders (limited partners) are deemed to carry on the business, hold property, and do everything the LTC (limited partnership) does, with the proviso “unless the context requires otherwise”.

As the legislation is currently drafted, it is not clear when the context requires otherwise. A number of the avoidance concerns appear to arise from the fact that a LTC is treated as partially transparent only rather than fully transparent. We consider that this needs to be looked at, and resolved, as a matter of priority and urgency, not just for LTCs, but also limited partnerships.

Technical changes

On the suggested technical changes to the deduction limitation rule:

- We agree with a balance sheet based starting point for the calculation of owner’s basis for companies entering the LTC regime.
- We support the proposal to include revaluations of real property in the owner’s basis calculations.

Chapter 6 – Qualifying companies

We welcome confirmation that existing qualifying companies (“QCs”) will be able to retain their status. This was a major concern hanging over the future of the QC regime.

We do not agree, however, that QCs should lose their QC status if there is a change in shareholding of over 50 percent in aggregate.

The stated policy concern is trading of QCs to access the tax preferences (including the ability to distribute capital gains prior to liquidation). This was not a policy issue identified at the time the QC regime was legislated for. This must mean policy makers, at the time, were aware that shares in QCs could be sold, with the accompanying transfer of tax preferences, and did not have concerns about this. We consider that the “distortion” of allowing untaxed gains to be distributed does not support a change in position.

At a practical level, we have also not seen such trading activity occur. It would be helpful if Officials could outline the extent of their concern, in order to evaluate if the rule is necessary.

If the proposal proceeds, there needs to be “rollover relief” (i.e. QC status should not be lost) where the change in shareholding is due to family succession.

It should also be made clear the proposed shareholder continuity measurement period starts from the date of enactment of the amending legislation. Any prior shareholding changes should not be counted for the purposes of the “50 percent in aggregate” shareholding change test. To do otherwise would effectively make this change retrospective, and it was clearly not the original policy intention that changes in shareholding should disqualify a company from QC status.

Chapter 7 – Transitioning into the LTC regime

Entry formula

The Issues Paper proposes that the “entry formula” calculation, on becoming an LTC, be undertaken at the relevant shareholder’s marginal tax rate.

We agree that the current entry tax adjustment results in a tax advantage to 33% (and 30%) tax rate shareholders, in respect of pre-LTC tax paid retained earnings.

This has resulted in the Commissioner releasing a tax avoidance QWBA (QB 14/11) which has created uncertainty around the operation of LTC rules. Once the legislative change is effective, the Commissioner should retract her QWBA item on LTCs.

We note that the current entry formula will not result in a taxable income amount for a shareholder to the extent of tax paid retained earnings. This is because *dividends + balances*, in the entry formula, will be offset by *balances/tax rate*. As a result there are no adverse non-tax outcomes for shareholders, such as a reduction in their family assistance entitlements, or additional student loan or child support payment obligations.

The proposal to “treat the retained income and imputation credits as being distributed to the individual LTC shareholders, who would include the income and credits in their return of income”, in contrast, will also trigger non-tax obligations. We believe this aspect has not been given due consideration.

The application of the entry formula should not result in adverse non-income tax outcomes for shareholders in LTCs. This is particularly the case as the deemed liquidation will not result in any actual cash being distributed to shareholders.

QCs transitioning to LTCs

The Issues Paper proposes the normal LTC entry adjustment will be required on transition of a QC, with the QC’s retained income and imputation credits being distributed to the shareholders. Any accumulated losses under the QC rules will be forfeited.

At the time of the introduction of the LTC rules, the Government indicated that it would also undertake a review of the dividend rules for closely-held companies, to simplify their operation.

We believe a number of those QCs will have held off becoming LTCs, in the hope that the tax review of close company dividends would lead to a simpler regime than the LTC rules. This has not eventuated. While the Issues Paper considers some issues around close company dividends, the actual proposals are limited in scope and/or subject to further consideration as part of Inland Revenue’s Business Transformation process.

In these circumstances, we do not believe it is fair to penalise taxpayers who have held off on transitioning from QCs to LTCs in the hope that the close company dividend review would yield greater change than now appears to be the case.

We therefore recommend that a further transitional period be allowed for QCs to become LTCs without adverse tax consequences. This should mirror the 2 year transition period originally allowed at the time of introduction of the LTC rules.

Values at time of entry

The Issues Paper proposes a retrospective technical change to clarify that, on conversion to an LTC, the values at which the assets and liabilities are deemed to be held by the owners are the tax book values. This rule will apply for both an ordinary company and a QC that converts to an LTC.

We do not support a retrospective change as this could have significant adverse consequences for companies that have become LTCs. Further, there is no analysis of the actual problem, and its extent in the Issues Paper, to justify the change.

We believe the haste with which the LTC rules were enacted will have contributed to the lack of clarity around entry values. Taxpayers should not be penalised for deficiencies in the rules, when they have acted in good faith.

Chapter 8 – Debt remission

As a general comment, we have concerns with Officials' analysis that debt remission generates taxable income for an LTC's shareholders.

If LTCs are fully transparent, for tax purposes, then there should be no remission income as the shareholders are effectively lending to themselves – i.e. there is no debt and therefore nothing to remit. This suggests that LTCs are not fully transparent and that the shareholder holds the debt in a different capacity to their capacity as a shareholder in the LTC. This does not seem correct from a tax policy perspective.

This highlights the fundamental issue with the LTC regime: the lack of clarity as to how transparent (or opaque) the rules are intended to be. As noted above, this needs to be addressed, as a matter of urgency.

The reference to “unless the context requires otherwise”, in section HB 1(5) (and HG 2(1)) of the Act, should be replaced with specific rules which outline when an LTC (or limited partnership) is treated as a look-through and when it is not.

Related parties debt remission in asymmetric situations

Notwithstanding our comments above, we strongly support the proposal to ensure there is no debt remission income for shareholder creditors. We also support the application of any legislative fix from 1 April 2011 (the application date of the LTC rules), for maximum clarity.

We note that this approach is consistent with the Government's related parties' debt remission proposals, in response to the Commissioner's tax avoidance analysis of debt capitalisations.

Where LTC shareholder creditors have returned remission income previously, there should be the ability for those taxpayers to refile to “correct” their position.

Loans to partnerships

We support the proposal also applying to partnerships, to relieve a creditor partner's share of debt remission income when a partner has made a loan to a partnership and the loan cannot be repaid.

The application date of this change should mirror the proposed 2006-07 application date of the related parties' debt remission proposals.

Clarifying remission income on exiting the LTC rules

We understand the policy concern with debt remissions being delayed until after a company exits the LTC regime. However, if as stated in paragraph 8.13 the position is clear that shareholders were always liable for any debt remission income on revocation of LTC status, it is unclear to us why a retrospective law change is now required.

Further, given our earlier comments that there should be no debt remission income where the funding is provided by shareholders (if an LTC is intended to be fully transparent in its dealings with shareholders, which we believe should be the case), the debt remission rules should only apply to third party debt remissions that arise on liquidation or an election to leave the LTC regime.

Chapter 9 – Dividend simplification

We welcome and support the proposals to simplify the dividend rules for close companies. Our concern is that the scope of change being proposed is relatively limited. In particular, we are disappointed that the ability to access capital gains tax-free has not been addressed for close companies that are not LTCs or QCs. This is a fundamental omission, given the time taken to complete the review of close companies.

Further, the more substantive changes to streamline RWT on close company dividends and interest have been deferred for consideration under the Business Transformation changes. Given the many moving parts of that reform, the timing of change may be a few years away at best.

Tainted capital gains when capital asset sold to non-corporate associated person

We support the proposal to remove the tainting of a capital gain when an asset is sold by a close company to a non-corporate associated person. This is a welcome change. However, given the implications of the *Concepts 124* decision, for associated persons in a trust context, it should be legislatively clarified that a transaction with an associated trust will not give rise to tainting.

We are disappointed that the removal of tainting does not apply more widely to transactions:

- Between companies other than close companies (i.e. widely-held companies) and non-corporate associated persons; and
- Between companies in the same group.

The stated policy concern is assets being sold to group entities to increase the capital gain amount available to shield distributions. The Issues Paper notes that the restriction dates back to the 1980s.

Economically, if the assets have genuinely increased in value there should be recognition of this, regardless of whether the “gain” is realised by sale to a third party or to an associate.

We believe the key here needs to be that the transfer of the assets is at market value, to address the concern that values may be inflated. This could be buttressed, if required, by changes to the depreciation rules to limit the associated purchaser’s cost base to the cost to the vendor. (We note that this concern should not be a problem where the asset is a building, as these have a nil depreciation rate.)

Potential related issue

The Issues Paper asks whether transactions which result in the former owners holding shares as a result of the transaction (and where the transaction gives rise to a related party capital gain) should be free from tainting. As noted above, we believe the gains should not be tainted if they are based on a market value realisation.

Tainted capital gains when capital asset owned by more than one company in a group

If our submission to remove tainting of gains realised between companies in the same group is not accepted, we support the more limited proposal to determine the tax-free amount available on distribution without reference to tainted capital gains. (This effectively ignores any tainted capital gains arising on intra-group transactions.)

We agree with the statement in paragraph 9.10 that there should be no limit on the type of companies to which this proposal could apply.

RWT compliance issues

We support:

- The optional removal of RWT on close company interest and dividend payments to shareholders.

The Issues Paper suggests this should be buttressed by a director guarantee that they will be liable for any unpaid tax of the shareholders on these amounts. To the extent the directors are also the shareholders, or related parties, we question the value of the guarantee. We are also concerned that further work on this issue is being deferred for consideration as part of Inland Revenue’s Business Transformation project. Given the length of time already taken, there needs to be more immediate action in relation to this proposal.

- The optional removal of 5% RWT on fully imputed dividends between companies that are not wholly-owned.

There is no sensible tax policy reason for this requirement, when the company rate is 28%. Therefore, we would go further and recommend that the RWT requirement for inter-company dividends be removed altogether, rather than making this optional.

- The option to combine cash and non-cash dividend payments as a single cash payment, where the cash dividend is sufficient to cover the total RWT.

The requirement to gross up the non-cash dividend means additional RWT must be withheld, even though this additional amount is ultimately refundable to the shareholder and comes at an additional cash cost to the payer. This highlights the cash-flow issue many companies face with the current gross-up requirement for deducting RWT on non-cash dividends generally. This wider issue also needs to be looked at, in our view.

- The option to deduct PAYE on some payments to shareholder employees and provisional tax on others.

As the Issues Paper notes, it is common from small business particularly to pay shareholder employees a base salary, and to top this up at year end once profitability is known. While we acknowledge the rationale for a consistency requirement, this needs to be sufficiently flexible to deal with the impact of variances in profitability and capital needs of the company on shareholder salaries.

Other issues – “natural person” shareholders of close companies

The definition of a natural person shareholder, in the context of the close company definition, needs clarification. We understand the Commissioner’s view is that a natural person includes a trust. This should be confirmed, as it is currently unclear whether a trust can be a shareholder of a close company.