

Regulatory Impact Statement

Review of closely held company taxation

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address the key concerns with the look-through company (LTC) rules and the dividend rules as they apply to closely held companies more generally. These key concerns can be grouped into three themes: rules which impose unnecessary compliance costs, rules which restrict legitimate commercial practice and rules which fail to achieve their intended policy objectives.

A range of policy options are considered to address the key concerns. The options are intended to simplify the rules and reduce compliance costs for closely held companies, while ensuring the rules are robust and in line with stated policy.

The proposals discussed were developed in the context of the wider tax policy framework for closely held company taxation to ensure they were consistent with the framework. However, questions as to the wider policy settings such as whether closely held companies in general should be able to distribute capital gains tax-free during the course of business, not just on liquidation (some closely held companies are already able to do this), were considered too complex and better handled through the standard tax work programme process at a future date.

Because of data limitations it is not possible to accurately forecast some of the costs (including compliance, administrative and fiscal costs) which may result from some of the proposals due to difficulty in estimating likely behavioural changes. For example, with regard to the proposed liberalisation of the tainted capital gains rule, it is difficult to reasonably estimate the number of companies with tainted gains which are choosing not to liquidate as a result of the tax impost that would arise. Wherever possible, the analysis provides fiscal implications arising from the proposals as forecasted.

Some of the recommended options will give rise to some additional compliance and administrative costs (as noted in the detailed options analysis) but it is difficult to provide precise estimates. The precise cost for companies and their shareholders resulting from, for example, the recommended changes to the LTC eligibility criteria or, alternatively, as a result of a choice to transition to another business model, will depend on the chosen model.

We note that the LTC regime is elective, so business owners have a choice to move into an alternative business form which does not have the same tax features and limitations. Various factors may influence this decision, such as the desire to use tax losses personally versus the familiarity with the corporate structure and the advantages of limited liability, which make full and accurate analysis of behavioural changes impossible.

Equally it is difficult to estimate the likely administrative costs to Inland Revenue as a result of on-going enforcement or monitoring activity required where the integrity of the rules is not strengthened. For example, if the proposed changes to the LTC entry tax are not progressed there is a potential risk of this rule being taken advantage of as part of tax avoidance arrangements; this would result in additional administrative costs in both detection and enforcement activities.

There are no other significant constraints, caveats or uncertainties concerning the analysis undertaken.

None of the policy options restrict market competition, impair property rights, reduce incentives for small businesses to operate, or override fundamental common law principles.

Geoff Leggett
Senior Policy Advisor, Policy and Strategy
Inland Revenue

2 December 2015

EXECUTIVE SUMMARY

1. Small closely held companies represent a significant proportion of New Zealand's 400,000 companies. The tax treatment of companies is generally different than that applied to individuals, including sole traders. Certain types of closely held companies are able to apply specific tax rules to help bridge the boundary between the two tax approaches. Therefore, the policy intent of these specific rules is to ensure that tax consequences do not discourage incorporation of businesses.
2. In 2010 the Government made major changes to the rules used by many closely held companies, including the introduction of a full flow-through vehicle, LTCs. Subsequently, in response to concerns, the Government undertook to review the LTC rules alongside aspects of the dividend rules applying to closely held companies more generally. In September 2015, Inland Revenue released an issues paper titled *Closely held company taxation issues* which suggested a package of proposed changes.
3. The policy development of the various options has been informed by both targeted consultation, over several years with representatives of the Chartered Accountants of Australia and New Zealand (CAANZ) tax advisory group. The Treasury were also involved in the policy development of the recommended proposals and agree with the conclusions.
4. The issues paper acknowledged that a number of problems exist with the way that the LTC rules operate and feedback was sought on various amendments to address them, the problems included in relation to the rule that limits an owner's deductions to the amount that they have at risk (the deduction limitation rule) and how debt remission is treated under a LTC or partnership. Officials also sought feedback on several proposals aimed at better targeting the LTC rules to ensure their use remained in line with the underlying policy intent, through tightening up some of the eligibility criteria.
5. Outside of LTCs, the issues paper outlined proposals in response to concerns raised regarding the dividend rules that apply to other closely held companies, primarily in relation to resident withholding tax obligations and the treatment of capital profits arising from transactions with associated parties.
6. A total of seventeen submissions were received in response. Some focussed on particular proposals or technical detailed queries, while others provided comment on the package more broadly. Submitters were generally supportive of the proposals which addressed technical errors and amended or removed rules. On the other hand, the proposals designed to ensure that the use of LTCs is better targeted at the originally intended audience were generally perceived as unnecessary or overly restrictive.
7. The proposals and alternative options have been reconsidered in light of submissions and a number of amendments are now recommended, all of which are expected to be positively received. For example, transitional and grand parenting arrangements are recommended to assist those affected by the proposed tightening of the LTC qualifying criteria. Also the proposal to limit the rule that taxes capital gains on asset sales to associated persons has been significantly expanded.

8. Our preferred options, and the details of the various proposals, are outlined further below. Given the wide ranging and technical nature of the proposals this RIS is, of necessity, detailed. As noted above, the concerns with the current settings can be grouped into three themes. To assist readers, the proposals, analysis and recommendations have been grouped under those themes.

9. If approved, the preferred options will require legislative changes to the Income Tax Act 2007. We recommend any legislative changes be included in the omnibus taxation bill scheduled for introduction in March 2016. Most changes would apply from the start of the 2017-18 income year, although some would be back dated. We note that the bill will be subject to a further public consultation process as part of the select committee process.

10. Several options are recommended to address these problems, and analysis of these options is summarised below.

11. We note that there are some minor proposals, primarily remedial or technical in nature, which have been identified during the review. These proposals are listed in appendix 2, but due to their minor or remedial nature no further options analysis has been provided in this RIS.

12. There are also a number of amendments which were either considered at the time of the review but subsequently not progressed, or raised by submitters in response to the issues paper; which are not discussed in this RIS. Officials have recommended that these amendments either be declined or progressed as a separate project on the basis that the issues are considered too complex and are better handled through the standard tax policy work programme process at some future date. A list of these issues, and a brief summary of official's decisions on them, is contained in appendix 3.

STATUS QUO AND PROBLEM DEFINITION

Summary of current settings

13. The review of the taxation issues facing closely held companies has focussed primarily on the following rules:

- the LTC rules – including the rules governing the LTC eligibility criteria, transitions into the LTC regime, the deduction limitation rule and the debt remission rule as it applies to LTCs;
- the qualifying company rules – in particular whether QCs should be retained or repealed;
- the wider dividend rules including the resident withholding tax obligations for closely held and ordinary companies, the tax treatment of cash and non-cash dividends and shareholder salaries;
- and the operation of the rule which treats capital gains made on transfers of property between associated persons as taxable upon liquidation, referred to as the ‘tainted capital gains rule’.

14. The QC and LTC rules were designed to alleviate some of the tax disadvantages that can arise from incorporation for closely held businesses. The broad objective of these rules is that operators should face similar taxation consequences regardless of the business structure through

which they chose to operate; for example a builder operating in their own name or as an incorporated business.

15. The QC rules, which date back to the early 1990's, allow for ordinary company taxation of profits (that is, profits are taxed at the standard company tax rate with subsequent distributions being taxed at shareholders' personal tax rates with imputation credits attached) but with tax-free flow through of capital gains. Before 2011 QCs could also elect to be loss-attributing qualifying companies (LAQCs) for tax purposes which allowed the company's losses to flow through to shareholders for offset against their other income.

16. Once the top personal rate was no longer aligned with the company rate there was a concern that the QC regime went beyond the objective of removing the tax disadvantages from incorporation, and in fact provided a potential tax advantage. Consequentially, in Budget 2010 the Government announced its intention to abolish QCs and LAQCs. Due to stakeholder concerns raised at the time, the decision was made to only abolish LAQCs. Existing QCs were grandfathered for the time being until a wider review of the dividend rules applying to closely held companies could be completed. At the end of the 2014 income year there were still around 70,000 QCs.

17. As part of the 2010 changes, the LTC rules were introduced as an alternative tax vehicle for closely held companies. They enable the LTC to be treated as a company for legal purposes but treated like an individual, sole trader or partnership for tax purposes. It is therefore "looked through" for tax purposes, with its income and expenditure being attributed back to shareholders and taxed at their personal tax rates. Untaxed gains, such as capital gains, earned at the company level are able to flow through tax free to the owners and likewise company losses can be utilised by the owners against their other income.

18. For closely held companies that are neither LTCs nor QCs, standard company tax rules apply.

Problems with the current tax settings

19. Several issues were noted during the review of the rules referred to above. These issues can be grouped as follows:

- **Rules which impose unnecessary compliance costs** – this includes some of the LTC rules which are overly complex to apply (for example the deduction limitation rule);
- **Rules which restrict commercial practice** – this includes rules which are inflexible or restrict non-tax driven legitimate commercial practice which would occur but for the rules (for example the rule which restricts a LTC from having more than one class of share and the tainted capital gains rule); and
- **Rules which fail to achieve their intended policy objectives** – this includes both current rules which are not operating in line with intended policy or allow for unintended tax advantages, as well as current rules which are not robust enough and can be easily circumvented (for example the LTC eligibility criteria which are not sufficiently targeted in some areas to protect the integrity of the regime).

20. The specific details of these rules and the current problems are discussed further below under these three headings. We note, however, that some of the problematic rules could have been grouped under more than one heading.

Rules which impose unnecessary compliance costs

21. Several of the rules were, upon review, seen to be imposing unnecessary compliance costs. These rules and the specific concerns relating to them are discussed below.

Deduction limitation rule

22. To ensure LTCs cannot be used to generate deductions in excess of the money that owners have at risk in the company, the rule restricts an owner's ability to utilise LTC deductions against their other income when the deductions are greater than their economic losses from the LTC. This rule is referred to as the deduction limitation rule.

23. The rule results in undue compliance costs in many cases as it requires each LTC owner to calculate their 'owner's basis' annually, which requires owners to keep track of what they have invested in and withdrawn from the business and all income and expenditure attributed to them while they have been an owner. Over time this would require LTC owners to maintain records well beyond the standard record keeping requirements for tax information. The calculation must be completed by every owner even though most will not have their deductions constrained by it because their share of expenditure is less than their owner's basis.

24. Moreover the rule has some technical issues in the way that it is drafted which can mean that it restricts deductions in some situations when all costs would be deductible if earned directly by the owners, which is not in line with the intended policy behind the LTC rules (namely, to parallel the tax treatment under direct ownership).

RWT on dividends between companies

25. The payment of passive income, such as dividends and interest, to resident recipients is subject to an obligation to account for RWT, which is withheld by the company at the time of payment and paid to Inland Revenue in the month following payment. For dividends a flat rate of 33% applies (less any imputation credits) and for interest, the RWT rate varies according to the recipient's personal tax rate.

26. As a result of the lowering of the company tax rate to 28%, when a company pays a fully imputed dividend (that is a dividend from retained earnings previously taxed at 28%) the dividend is still subject to an additional 5% RWT (a total of 33%). For dividends paid to corporate shareholders (who will be subject to the company tax rate of 28%) this obligation to withhold RWT results in an initial over-taxation (of the additional 5%) of these dividends.

27. Unless the two companies are part of the same wholly-owned group or the recipient company holds a certificate of exemption from RWT, this over-taxation may give rise to additional compliance costs for both the paying company, which must account for the additional RWT to Inland Revenue, and the recipient company, which is required to seek a refund when the RWT credit cannot be used.

RWT on concurrent cash and non-cash dividends

28. When a company pays a non-cash dividend, such as a taxable bonus issue, the dividend is still subject to RWT. The legislation requires the non-cash dividend to be grossed up because the RWT cannot practically be withheld from the non-cash amount.

29. When a company pays a non-cash dividend concurrently with a cash dividend both dividends are subject to RWT. The legislation treats the two dividends separately and requires the non-cash dividend to be grossed up and the RWT applied on the gross amount. This gross up is required even when the concurrent cash dividend is sufficient to cover the RWT obligation on both dividends. This gross-up can therefore result in the RWT obligation across both dividends being higher than it should.

Rules which restrict commercial practice

30. As discussed, several of the rules were, upon review, seen to be inflexible or overly restrictive of non-tax driven legitimate commercial practice. These rules and the specific concerns relating to them are discussed below.

LTC restriction on share classes

31. Currently, in order to simplify the attribution of income and expenditure to shareholdings of look-through owners, LTCs can only have one class of share. This rule is overly restrictive in the light of the policy objective.

32. This limitation can restrict legitimate commercial structuring or generational planning and inhibit some companies from becoming LTCs. A parent, for example, because of their industry expertise, may want to retain control of the decision-making process when children are introduced into the business. It would be reasonable to do this through having shares that carry different voting rights. The current requirement is particularly problematic when the different classes of shares carry the same entitlements to distributions.

Tainted capital gains

33. Capital gains derived at the company level cannot be distributed tax free by ordinary companies, except upon liquidation. The tainted capital gain rule taints a capital profit if it is realised by a sale of a capital asset to an associated person (for example a group company or a significant shareholder) making it taxable upon liquidation, unless the gain is derived by a close company and arises during the course of liquidation.

34. The policy rationale for this rule is that sales of assets between associated persons (for example sales within a group of companies) can be for the purposes of creating additional amounts of capital reserves that can be distributed tax-free, rather than for general commercial reasons. This would allow a company to distribute 'capital profits' tax free in lieu of dividends, which would have been taxable.

35. The restriction dates back to the 1980s. Due to various tax system changes which have taken place over time (in particular, the introduction of the imputation regime and a comprehensive definition of dividend) the rule may have less relevance today.

36. In practice the tainting rule can capture genuine transactions when the sale is not tax driven, for example the transfer of an asset as part of a genuine commercial restructure. The restriction, therefore, extends beyond its intended ambit, and companies can often be

inadvertently caught by the rule, resulting in their being unable to be subsequently liquidated without a tax impost.

Options for taxing shareholder salaries

37. Shareholder-employees of close companies often do not derive regular amounts of salary or wages, or do not get paid in regular periods throughout the income year which can make compliance with the PAYE rules difficult. This is because the PAYE rules are designed for circumstances when employees' salaries are known at the start of the income year and remain steady (received in monthly or fortnightly payments) throughout the year.

38. For smaller companies the remuneration of shareholder-employees often depends on the performance of the business, and therefore the annual salary will not be known until well after year end. To alleviate this issue the current rules allow for shareholder-employees, who do not derive regular amounts of salary or wages or do not get paid for regular periods, to treat all amounts of income they receive through the year as not subject to PAYE, subject to certain conditions. As a result, the amounts received are taxable in the employee's tax return and may give rise to provisional tax obligations.

39. This rule may not adequately relieve the compliance costs incurred by shareholder-employees as it may not suit the myriad of shareholder-employee circumstances where paying a combination of PAYE and provisional tax might be preferable. There is no option, however, to pay a combination of PAYE and provisional tax, the rule is all or nothing.

Rules which fail to achieve their intended policy objectives

40. As discussed, several of the rules were, upon review, not operating in line with intended policy. This could mean that the rules are either not operating as intended or allow for unintended tax advantages or the rules may not be robust enough which has resulted in their use for purposes which are inconsistent with their policy intent. These rules and the specific concerns relating to them are discussed below.

LTC eligibility criteria

41. The eligibility criteria limit the type of entity that can elect to become and continue to be a LTC. Broadly, to be a LTC, in addition to having only one class of shares, an entity must be a New Zealand tax resident company with no more than five "look-through counted owners". Each shareholder has to be a natural person, a trust or another LTC. There are no restrictions on foreign ownership of LTCs, nor on foreign income earned by LTCs.

42. When determining the number of look-through counted owners the rules:

- count close relatives as a single owner;
- look through to the ultimate shareholder(s) when LTCs are owned by other LTCs;
- for LTCs owned by trusts, count trustees (grouping multiple trustees as one) or beneficiaries or both, depending on the nature of the distribution and whether LTC income is distributed by the trust in full.

43. A LTC that fails to satisfy the eligibility criteria during an income year, loses its LTC status from the beginning of the income year, and is unable to elect into LTC treatment for the remainder of that year and the two subsequent income years. Given that LTC owners are deemed to directly hold the LTC's assets and liabilities, loss of LTC status means that the LTC

assets are deemed to be disposed of by the LTC owners. This deemed disposal can trigger tax consequences, such as depreciation claw-back, for the owners.

44. These eligibility criteria were reviewed against the “target audience” for the LTC regime to ensure that the use of the LTC rules is appropriate in light of the policy intent underlying their design.

45. From a policy perspective, LTCs were intended to be used as investment vehicles for closely controlled (meaning five or fewer counted owners) New Zealand businesses which, for commercial reasons, preferred to make the investment through the corporate structure but that could otherwise have genuinely been made directly by an individual or small group of individuals, including through a family trust.

46. This means LTCs were not intended to be widely held vehicles, although the rules do envisage use by close family groups by allowing for all ‘relatives’ to be counted as one look-through owner (for example children, siblings and spouses).

47. The eligibility criteria are closely held companies, are overly liberal in several areas which has the potential to undermine this intended policy outcome. In particular, in relation to LTCs owned by trusts (including trusts with corporate beneficiaries), charities and Māori authorities, the current rules could allow for LTCs to be in effect widely held.

48. For LTCs held by trusts the current rule is limited in that it only counts beneficiaries who have received distributions of LTC income as ‘beneficiary income’ (being income which has not been taxed in the hands of the trustees) rather than all distributions that they receive sourced from any income of the trust. This allows for multiple beneficiaries to benefit from the LTC income but not become ‘counted owners’ by, for example, receiving only distributions of ‘trustee income’.

49. Further, because of the fungibility of money, it is only really possible to nominally trace the source of a distribution to test whether they are derived from a direct or indirect beneficial interest in a look-through interest. This means that the test which counts look-through owners based on the source of income which is distributed can be easily undermined, as income can be made to appear to be distributed from one particular source, but this may bear no semblance to what has happened in reality. In practice a dollar distributed by a trust may be sourced from any funds of the trust.

50. A trust that owns a LTC can currently have a corporate beneficiary but direct ownership by companies, other than other LTCs, is expressly prohibited. The trust is looked through and the shareholders of the corporate are counted if it receives any beneficiary income. This, coupled with the stated problems in the current trust counting rules as described above, unintentionally provides widely held non-LTC corporates with a way to circumvent the prohibition on direct ownership.

51. The current rules also allow for charities and Māori authorities to hold LTC interests, either directly or indirectly through a trust. Both charities and Māori authorities have potentially wide pools of beneficiaries and are, therefore, conceptually not part of the LTC target audience.

52. Finally, although LTCs are envisaged primarily as a structure for domestically focussed companies, currently there are no rules which restrict foreign investment by LTCs or foreign ownership of LTCs (i.e. having non-resident shareholders). This combination unintentionally

allows for LTCs to be used as conduit investment vehicles (vehicles used by foreigners to invest in foreign markets generating income which is generally not taxable in New Zealand).

53. There are reputational risks with allowing such conduit structures, and there is some anecdotal evidence that LTCs have been used to facilitate illegal activity, though they are not the only vehicle to be so used.

LTC entry tax

54. Given that a LTC can distribute its capital and reserves tax free to its shareholders, the LTC rules provide for a “LTC entry tax” when a company elects to become a LTC. The LTC entry tax calculation attributes income to the shareholders based on a notional liquidation of the company.

55. The rule triggers a tax liability on un-imputed retained earnings by deeming the company that elects into the LTC regime to have been liquidated immediately prior to conversion, except that there is no actual disposal or deemed disposal of assets. Thus, for example, revenue account property conceptually transfers at tax book value, and not market value, meaning that unrealised gains and losses are not crystallised.

56. This adjustment is intended to ensure that reserves that would be taxed to shareholders if distributed before entering the LTC regime and that would be able to be distributed tax-free once the company becomes a LTC, are taxed to shareholders at the time of entry.

57. The LTC entry tax rule has several issues in the way that it operates. The rate applicable to the ‘entry tax’ is 28%, to the extent that the company’s retained earnings are fully imputed. Under the LTC entry tax formula this income is regarded as being finally taxed at 28%. It is only the untaxed reserves that are taxed at the shareholder’s personal tax rates. This provides a tax advantage for shareholders whose top personal tax rate exceeds 28% (that is on the 30% or 33% marginal tax rate). Similarly this disadvantages shareholders whose personal tax rates are below 28%. The 28% rate was used in the formula to reduce compliance costs.

58. In the extreme example this differential in the rate has led to cashed up companies electing into the LTC regime and then subsequently liquidating, which means the income remains taxed only at the 28% rate (but we note that this might be seen as tax avoidance in some cases).

59. The entry tax adjustment also produces an incorrect outcome for QCs which convert to LTCs. This issue is discussed further in appendix 2, along with other remedial amendments.

Debt remission in the LTC context

60. Debt remission, being the extinguishing of a debtor’s liability by operation of law or forgiveness by the creditor, gives rise to debt remission income to the debtor under the financial arrangement rules. Under present tax law, debt remission produces taxable income to the debtor, but usually no tax deduction is available to the creditor as it is generally treated as a capital loss.

61. Proposals to address this asymmetric treatment of the remission in certain circumstances form part of a separate policy project and are not discussed further in this RIS. The proposals in this RIS focus only on the problems which arise from the interaction of the LTC (and partnership) rules with the financial arrangements rules that produce the remission income.

62. When an owner of a LTC remits debt owed to them by the LTC, all the LTC owners derive debt remission income as the LTC is looked through. This includes the owner that remitted the debt who is required to pay tax on their share of the remission income, despite the fact that they have actually made an economic loss (to the extent of the portion that is “attributed” to the other shareholders). Generally, the creditor shareholder is unable to claim a deduction for the bad debt. Overall, this results in over-taxation of the owner who remitted the debt, which is not an appropriate tax policy outcome.

63. There is a further issue regarding the recognition of debt remission income in circumstances where the LTC elects out of the LTC regime or is liquidated. This issue is discussed further in appendix 2.

QC status

64. Since the 2010 decision to grandparent QCs there has been a question around what to do with the remaining grandparented QCs. As part of the closely held company review officials considered the role of QCs and the desirability of retaining QCs. The decision was reached that existing QCs should continue to be grandparented, on the basis that requiring all remaining QCs to convert to LTCs, or failing that to ordinary companies, would not only impose significant compliance costs on those businesses but would also not be practical as the LTC requirements might not be suitable for many QCs.

65. This means that while no new QCs can be created, existing QCs can continue until they are either liquidated, elect out of the QC regime or fail to meet the QC eligibility criteria. This can provide them with a permanent tax advantage. This advantage would be due primarily to the potential tax deferral on income that is taxed until distribution at the company tax rate rather than the shareholders’ personal rates and the favourable treatment of capital gains relative to ordinary companies.

66. This permanent tax advantage could lead to a desire to trade the QC for tax purposes which has the potential to lead to undesirable tax behaviour, and is inconsistent with Parliament’s clear intention to restrict new persons entering the QC regime. In effect a new QC can be created by simply replacing the shareholders of an existing QC.

OBJECTIVES

67. The Government is committed to making positive changes to reduce the time and cost to businesses resulting from onerous tax compliance obligations. The closely held company taxation issues review was completed with this broad objective in mind.

68. The objectives against which the options for change have been assessed, and which support this wider Government commitment are:

- i. **Overall efficiency:** To support the overall economic efficiency of the tax system, the options should, to the extent possible, reduce distortions resulting from the tax treatment to ensure that taxpayers’ decisions are not tax driven.
- ii. **Fairness and neutrality:** To support fairness in the tax system, the options should, to the extent possible, seek to treat similar taxpayers or similar circumstances in a similar way. This can include ensuring that the rules are more robust so that a specific tax treatment, such as LTCs which help

fairness and neutrality at the margin, cannot be used far more broadly by those that should be taxed under the ordinary company rules.

- iii. **Efficiency of compliance and administration:** Compliance costs for taxpayers and administrative costs for Inland Revenue should be minimised as far as possible. The various closely held company tax rules, in particular the LTC rules, should be clear and simple to understand and apply.

69. The optimum options should:

- not lead to tax driven outcomes;
- minimise compliance costs for closely held companies;
- reduce the risk to the tax base through the use of LTCs in unintended ways; and
- provide certainty for taxpayers using the rules.

70. When assessing the options officials have also been mindful of the fiscal implications stemming from the proposals

71. The options discussed below have been developed in response to concerns raised with officials, by submitters during the review or in prior consultation with CAANZ, on the workability or appropriateness of the rules or in response to concerns uncovered by officials in completing the review.

REGULATORY IMPACT ANALYSIS

72. The options assessed in this RIS are grouped under the three key themes. Each option has been assessed against the stated objectives, and our conclusions are indicated in the tables below. Full details of the analysis of the advantages and disadvantages of all of the options are set out in Appendix 1.

73. For each option the analysis has weighed the likelihood of achieving the stated desired outcome, against the implications for taxpayers, focussing on the following groups:

- implications for taxpayers who have structures in place based on the current rules (this would including consideration of the compliance costs that may arise due to having to restructure as well as any tax consequences which may arise due to the change);
- implications for taxpayers looking to rely on the rules in the future (the analysis here focussed on the effect of the change on compliance costs and certainty in the rules); and
- taxpayers more generally (in terms of any implications which may arise from not proceeding with the proposals; for example the effect of not protecting the integrity of the LTC rules or allowing reputational risks).

74. To minimise any negative effects for the first group, several transitional and/or grandparenting rules are recommended to either ease the transition into the new rules or protect taxpayers who have structures in place based on the current rules.

75. Our analysis has also been informed by the comments received from submissions on the officials’ issues paper. The expected outcomes of each option has been considered and contrasted against the status quo (i.e. the current tax law that applies).

76. Generally the analysis has focussed on the economic, fiscal and compliance impacts of each of the options. Officials do not expect any of the options that are discussed or recommended to have social, environmental or cultural impacts and no additional analysis of these effects has been included.

77. Fiscal implications arising from the proposals have been provided, when these have been costed. Some options would have fiscal implications, but these are unable to be costed (due to for example unquantifiable behaviour changes).

78. Some of the recommended options will give rise to some additional compliance and administrative costs (as noted in the options analysis in Appendix 1). The precise cost for companies and their shareholders, resulting from both the recommended changes to the eligibility rules or, alternatively, as a result of a choice to transition to another business model, will depend on their chosen model.

79. However we note the LTC regime is elective, so business owners have a choice to move into a business form which does not have the same tax features and limitations. Various factors may influence this decision, such as the desire to use tax losses personally versus the familiarity with the corporate structure and the advantages of limited liability, which make full and accurate analysis of behavioural changes impossible.

Rules which impose unnecessary compliance costs

Deduction limitation rule

80. Options to address concerns around the complexity and targeting of the rule that restricts a look-through owner’s ability to claim LTC deductions in excess of the money they have invested in the business, are listed below:

Options:	Recommendations	Analysis against objectives
Option 1: Repeal the rule – entirely.	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency of costs:</i> Meets objective.
Option 2: Repeal the rule except for LTCs operating in partnership or joint venture with other LTCs, and make some technical clarifications to the rule for those still covered by it.	Recommended.	<i>Overall efficiency:</i> Meets objective. <i>Fairness/neutrality:</i> Meets objective. <i>Efficiency in costs:</i> Meets objective for the most part.
Option 3: Maintain the rule but make some technical clarifications to the rule.	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Partly meets objective. <i>Efficiency in costs:</i> Partly meets objective.
Option 4: Maintain the status quo.	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> Does not meet objective.

81. If the rule is repealed, as recommended under option 2 above, there is a question around the treatment of previously restricted deductions. Options for how the deductions will be released are discussed below:

Options:	Recommendations	Analysis against objectives
Option 1: Repeal the rule in part (refer option 2 above) and release previously restricted deductions in one lump at a particular point.	Recommended.	<i>Overall efficiency:</i> No impact. <i>Fairness/neutrality:</i> Mostly meets objective. <i>Efficiency in costs:</i> Meets objective.
Option 2: Repeal the rule in part (refer option 2 above) and require restatement of prior period returns on the basis that the rule had not existed.	Not recommended.	<i>Overall efficiency:</i> No impact. <i>Fairness/neutrality:</i> Meets objective. <i>Efficiency in costs:</i> Does not meet objective.
Option 3: Repeal the rule in part (refer option 2 above) and gradually release previously restricted deductions over three years.	Not recommended.	<i>Overall efficiency:</i> No impact. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> Does not meet objective.

RWT on dividends between companies

82. Options to address concerns around the initial over-taxation of fully-imputed dividends paid to corporate shareholders, as well as to minimise the unnecessary compliance costs arising from the RWT obligations which apply are:

Options:	Recommendations	Analysis against objectives
Option 1: The obligation to account for RWT on all fully-imputed dividends paid between companies should be removed.	Not recommended.	<i>Overall efficiency:</i> Partly meets objective. <i>Fairness/neutrality:</i> Partly meets objective. <i>Efficiency in costs:</i> Partly meets objective.
Option 2: The obligation to account for RWT on all fully-imputed dividends paid between companies should be optional.	Recommended.	<i>Overall efficiency:</i> Meets objective. <i>Fairness/neutrality:</i> Meets objective. <i>Efficiency in costs:</i> Meets objective.
Option 3: The obligation to account for RWT on all fully-imputed dividends paid between companies should be maintained (status quo).	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> Does not meet objective.

RWT on concurrent cash and non-cash dividends

83. Options to address concerns around the over-taxation of cash and non-cash dividends paid concurrently, as well as the unnecessary compliance costs arising from the RWT obligations which apply are:

Options:	Recommendations	Analysis against objectives
----------	-----------------	-----------------------------

Option 1: A taxpayer should be able to opt to treat cash and non-cash dividends paid concurrently as a single dividend, when the cash dividend is sufficient to cover the RWT obligations for both dividends.	Recommended.	<i>Overall efficiency:</i> Meets objective. <i>Fairness/neutrality:</i> Meets objective. <i>Efficiency in costs:</i> Meets objective
Option 2: A taxpayer should not be able to opt to treat cash and non-cash dividends paid concurrently as a single dividend, with the two dividends remaining separate for the purposes of the RWT obligations (status quo).	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> Does not meet objective.

Rules which restrict commercial practice

LTC restriction on share classes

84. Options to address the concern that the restriction applying to LTC shares unduly restricts commercial practice are:

Options:	Recommendations	Analysis against objectives
Option 1: LTCs should have the option of having more than one share class.	Not recommended.	<i>Overall efficiency:</i> Partly meets objective. <i>Fairness/neutrality:</i> Partly meets objective. <i>Efficiency in costs:</i> Does not meet objective.
Option 2: A LTC should be able to have more than one class of shares provided all shares still have uniform entitlements to distributions from the LTC (i.e. differentiate on voting rights only).	Recommended.	<i>Overall efficiency:</i> Meets objective. <i>Fairness/neutrality:</i> Mostly meets objective. <i>Efficiency in costs:</i> Meets objective.
Option 3: LTCs should continue to be restricted to having just one share class (status quo).	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> No impact.

Tainted capital gains

85. Options to address the concerns that the tainted capital gains rule has overreach and unduly restricts commercial practice are:

Options:	Recommendations	Analysis against objectives
Option 1: Repeal the rule.	Not recommended.	<i>Overall efficiency:</i> Meets objective, as poses tax avoidance risk. <i>Fairness/neutrality:</i> Partly meets objective, to extent that rule has over-reach. <i>Efficiency in costs:</i> Partly met – simplifies rules but the additional tax avoidance risk may require extra Inland Revenue enforcement.
Option 2: Restrict the rules to apply only to the wholly-owned group context.	Not recommended.	<i>Overall efficiency:</i> Mostly meets objective. <i>Fairness/neutrality:</i> Mostly meets objective. <i>Efficiency in costs:</i> Mostly meets objective.

Option 3: Restrict the rules to apply only to the wholly owned group context and to sales of assets where less than 15% of the asset has been sold to a third party (i.e. 85% of the asset is held indirectly by the original owners).	Recommended.	<i>Overall efficiency:</i> Meets objective. <i>Fairness/neutrality:</i> Meets objective. <i>Efficiency in costs:</i> Meets objective on balance between costs to taxpayers and Inland Revenue.
Option 4: Do not repeal the rule (status quo).	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> Does not meet objective.

Options for taxing shareholder salaries

86. Options to address the concerns that the PAYE and provisional tax rules do not provide sufficient flexibility for shareholder employees whose earnings are irregular are:

Options:	Recommendations	Analysis against objectives
Option 1: Shareholder employees should be able to choose between a mix of PAYE and provisional tax on their salaries, and the choice of method is unrestricted period to period.	Not recommended.	<i>Overall efficiency:</i> Partly meets objective. <i>Fairness/neutrality:</i> Partly meets objective. <i>Efficiency in costs:</i> Partly meets objective but poses tax avoidance risk which may raise costs of Inland Revenue enforcement action.
Option 2: Shareholder employees should be able to choose between a mix of PAYE and provisional tax on their salaries, and the choice of method is restricted period to period to prevent flip-flopping between methods in succeeding periods.	Recommended.	<i>Overall efficiency:</i> Meets objective. <i>Fairness/neutrality:</i> Meets objective <i>Efficiency in costs:</i> Meets objective, balances benefits to taxpayers and costs to Inland Revenue.
Option 3: Shareholder salaries should be subject to either PAYE or provisional tax, but not both (status quo).	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> Does not meet objective.

Rules which fail to achieve their intended policy objectives

LTC eligibility criteria

87. Options to address the concern that for LTCs owned by trusts the fact that the current eligibility criteria focus only on distributions of beneficiary income when counting look-through owners is not robust enough to ensure that LTCs are not more widely held than intended are:

Options:	Recommendations	Analysis against objectives
-----------------	------------------------	------------------------------------

Option 1: Extend the 'look-through counted owners' test to include all beneficiaries who receive any distributions (whether as beneficiary income or trustee income, corpus or capital) from LTC shareholding trusts.	Recommended.	<i>Overall efficiency:</i> Meets objective, less tax driven behaviour. <i>Fairness/neutrality:</i> Meets objective, by supporting integrity of the LTC rules by helping to ensure LTCs are closely held. <i>Efficiency in costs:</i> Somewhat met, requires trustees to track all distributions, but does provide greater certainty by not differentiating between distributions.
Option 2: Remain with status quo, and count only distributions of beneficiary income from LTC interests.	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> No impact.

88. Options to address the concern that the current restriction around corporate ownership of LTCs is not robust enough to ensure that LTCs are not indirectly owned by corporates through trusts, are listed below:

Options:	Recommendations	Analysis against objectives
Option 1: Trusts that own LTCs should not be allowed to have corporate beneficiaries.	Not recommended.	<i>Overall efficiency:</i> Partly meets objective. <i>Fairness/neutrality:</i> Meets objective, but in practice would exclude many existing LTCs. <i>Efficiency in costs:</i> Does not meet objective as may result in tax-driven restructuring.
Option 2: Trusts that own LTCs should be allowed to have corporate beneficiaries so long as no distributions are made to those corporate beneficiaries.	Recommended.	<i>Overall efficiency:</i> Mostly meets objective as tax-driven behaviour less likely. <i>Fairness/neutrality:</i> Mostly meets objective and takes into account current structures. <i>Efficiency in costs:</i> Mostly meets objective, but may raise risk of inadvertent breach.
Option 3: Trusts that own LTCs should be allowed to have corporate beneficiaries.	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. May encourage behavioural change by corporates. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> Increased tax avoidance risk may raise costs of Inland Revenue enforcement action.
Option 4: Trusts that own LTCs should be allowed to have corporate beneficiaries if the total number of counted owners (including all shareholders of the corporate beneficiary) remains below 5(status quo).	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> No impact.

89. Options to address the concern that for LTCs owned by charities (directly or indirectly through trusts) the fact that the current eligibility criteria focus only on distributions of beneficiary income when counting look-through owners is not robust enough to ensure that these LTCs are not more widely held than intended, are listed below:

Options:	Recommendations	Analysis against objectives
-----------------	------------------------	------------------------------------

Option 1: Charities are precluded from owning LTCs directly or indirectly, with no allowance for distributions akin to donations.	Not recommended.	<i>Overall efficiency:</i> Does not meet objective as will encourage tax-driven restructuring. <i>Fairness/neutrality:</i> Does not meet objective. May support integrity of LTC rules but disadvantages charities through precluding genuine donations. <i>Efficiency in costs:</i> Does not meet objective as costs associated with any restructuring.
Option 2: Charities are precluded from owning LTCs either directly or indirectly, but are allowed to make charitable distributions (capped at 10% of net LTC income received by the trust in the year).	Not recommended.	<i>Overall efficiency:</i> Partly meets objective as will be less restructuring but may discourage true donations which is inefficient. <i>Fairness/neutrality:</i> Partly meets objective. <i>Efficiency in costs:</i> Does not meet objective as results in compliance costs to track distributions.
Option 3: Charities are precluded from owning LTCs directly, but not precluded from indirectly benefiting from the LTC as either residual beneficiary of a LTC owning trust, or ordinary beneficiaries when the charity has no influence over the LTC or trust (in effect any distribution is a true gift which is freely given).	Recommended.	<i>Overall efficiency:</i> Mostly meets objective as will not lead to tax-driven restructuring and will not discourage true donations. <i>Fairness/neutrality:</i> Mostly meets objective. <i>Efficiency in costs:</i> Mostly meets objective.
Option 4: Charities should be able to own LTC interests (status quo).	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. In effect allows widely held 'ownership'. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> No impact.

90. Options to address the concern that for LTCs owned by Māori authorities (directly or indirectly through trusts) the fact that the current eligibility criteria focus only on distributions of beneficiary income when counting look-through owners is not robust enough to ensure that these LTCs are not widely held vehicles, are listed below:

Options:	Recommendations	Analysis against objectives
Option 1: Māori authorities are precluded from owning LTCs directly or indirectly.	Not recommended.	<i>Overall efficiency:</i> Partly meets objective as may simply result in restructuring to other look-through vehicles given problems in using excess imputation credits from separate business subsidiaries. <i>Fairness/neutrality:</i> Partly meets objective by treating corporate subsidiaries of Māori authorities equivalently to their competitors. <i>Efficiency in costs:</i> Does not meet objective as may be restructuring costs.
Option 2: Māori authorities are precluded from owning LTCs directly or indirectly, but existing structures are grand-parented.	Recommended.	<i>Overall efficiency:</i> Partly meets objective and reduces likelihood of restructuring. <i>Fairness/neutrality:</i> Partly meets objective. <i>Efficiency in costs:</i> Meets objective, as limits impact on compliance costs.

Option 3: Māori authorities are not precluded from owning LTCs directly or indirectly (status quo).	Not recommended.	<i>Overall efficiency:</i> Does not meet objective as enables widely held ownership. <i>Fairness/neutrality:</i> Does not meet objective. May be competition issues. <i>Efficiency in costs:</i> No impact on compliance costs.
---	------------------	---

91. Options to address the concern that LTCs are currently able to be used as conduit investment vehicles, are listed below:

Options:	Recommendations	Analysis against objectives
Option 1: Foreign owners should not be able to own LTCs at all.	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. Prevents conduit investment but restricts inbound foreign investment through a LTC. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> Does not meet objective, as would result in significant transitional costs.
Options 2: Foreign owners should be able to own LTCs but not earn any foreign income.	Not recommended.	<i>Overall efficiency:</i> Does not meet objective. Prevents conduit investment but precludes outbound investment through a LTC, including personal services income. <i>Fairness/neutrality:</i> Does not meet objective. Foreign investment can be done directly. <i>Efficiency in costs:</i> Does not meet objective, as would result in significant transitional costs.
Option 3: Foreign owners should be able to own LTCs, but LTCs that are foreign controlled (i.e. 50% foreign owned) should only be able to earn a limited amount of foreign income.	Recommended.	<i>Overall efficiency:</i> Meets objective, without unduly restricting foreign investment (inbound and outbound). <i>Fairness/neutrality:</i> Meets objective, by supporting the integrity of the LTC rules and better targeting of restriction. <i>Efficiency in costs:</i> Meets objective, as limits transitional costs to relatively few LTCs.
Option 4: Foreign ownership of LTCs should not be restricted and the ability to earn foreign income should not be restricted (status quo).	Not recommended.	<i>Overall efficiency:</i> Does not meet objective given reputational concerns. <i>Fairness/neutrality:</i> Does not meet objective. <i>Efficiency in costs:</i> No impact.

LTC entry tax

92. Options to address the concern that the LTC entry tax is not operating as intended, are listed below:

Options:	Recommendations	Analysis against objectives
Option 1: The entry tax formula should be amended to change the tax rate that applies to any income calculated by the adjustment, to the LTC shareholder's personal tax rates.	Recommended.	<i>Overall efficiency:</i> Meets objective. <i>Fairness/neutrality:</i> Meets objective, by ensuring income is taxed at correct tax rates and minimising tax avoidance risk. <i>Efficiency in costs:</i> Mostly meets objective.

Option 2: The entry tax formula should not be amended to change the tax rate that applies to any income calculated by the adjustment (status quo).	Not recommended.	<p><i>Overall efficiency:</i> Does not meet objective.</p> <p><i>Fairness/neutrality:</i> Does not meet objective, as does not address unfairness in current over/under taxation depending on applicable personal tax rates.</p> <p><i>Efficiency in costs:</i> Does not meet objective. No impact on compliance costs but may be enforcement costs.</p>
--	------------------	--

Debt remission in the LTC context

93. Options to address the concern that the interaction of the financial arrangement rules and LTC rules results in unintended debt remission income for creditor-shareholders, are listed below:

Options:	Recommendations	Analysis against objectives
Option 1: Debt remission income should not arise for the shareholder-creditor when the debt is forgiven.	Recommended.	<p><i>Overall efficiency:</i> Meets objective.</p> <p><i>Fairness/neutrality:</i> Meets objective.</p> <p><i>Efficiency in costs:</i> No impact.</p>
Option 2: Debt remission income should arise for the shareholder-creditor when the debt is forgiven, but they should get a bad debt deduction to offset the income.	Not recommended	<p><i>Overall efficiency:</i> Does not meet objective, as it may remove one distortion but it is inconsistent with the general treatment of capital losses.</p> <p><i>Fairness/neutrality:</i> May not meet objective.</p> <p><i>Efficiency in costs:</i> No impact.</p>
Option 3: Debt remission income should arise for the shareholder-creditor when the debt is forgiven, and they should not get a bad debt deduction to offset the income (status quo).	Not recommended	<p><i>Overall efficiency:</i> No effect.</p> <p><i>Fairness/neutrality:</i> Does not meet objective.</p> <p><i>Efficiency in costs:</i> No impact.</p>

QC status

94. Options for what should be done with remaining grand-parented QCs are listed below:

Options:	Recommendations	Analysis against objectives
Option 1: Repeal the QC regime.	Not recommended.	<p><i>Overall efficiency:</i> Meets objective by limiting the number of available structures, but forces re-structuring for current QCs.</p> <p><i>Fairness/neutrality:</i> Partly meets objective.</p> <p><i>Efficiency in costs:</i> Does not meet objective as raises costs for current QCs which must convert.</p>
Option 2: Maintain grand-parenting but allow remaining QCs to continue (status quo).	Not recommended.	<p><i>Overall efficiency:</i> Does not meet objective, as allows any tax advantage to be traded.</p> <p><i>Fairness/neutrality:</i> Does not meet objective, as allows QCs to maintain any tax advantage.</p> <p><i>Efficiency in costs:</i> No impact.</p>

<p>Option 3: Allow remaining QCs to continue but QC status would be lost on the sale of any QC shares to new owners.</p>	<p>Not recommended.</p>	<p><i>Overall efficiency:</i> Partly meets objective, as continues any tax advantage but does remove scope for trading QCs. <i>Fairness/neutrality:</i> May unfairly result in loss of QC status upon a shareholding change which is not tax-driven. <i>Efficiency in costs:</i> Does not meet objective, as may lead to increased costs from unintended loss of status.</p>
<p>Option 4: Allow remaining QCs to continue but QC status would be lost if sufficient shares are sold so that there has been a change of control.</p>	<p>Recommended</p>	<p><i>Overall efficiency:</i> Partly meets objective, as continues any tax advantage but does remove scope for trading QCs. <i>Fairness/neutrality:</i> Meets objective by adequately restricting QC trading without capturing minor changes in shareholding. <i>Efficiency in costs:</i> Partly does not meet objective, as will be compliance costs if choose to sell sufficient shares to lose QC status.</p>

CONSULTATION

95. As part of the review process, officials held a series of meetings with a representative group from CAANZ’s tax committee out of which the September 2015 issues paper, titled *Closely held company taxation issues*, was prepared.

96. Seventeen submissions were received in response to the issues paper, mainly from accounting firms plus CAANZ, the New Zealand Law Society and the Corporate Taxpayers Group.

97. Overall, the various proposed liberalisations of the current rules were strongly supported including the remedial amendments. However, some submitters thought that the proposals in the issues paper did not go far enough. Submitters were generally less supportive of the proposals to tighten the rules on who could become a LTC shareholder, designed to ensure the LTC regime was better targeted at the original intended target audience. Our expectations are that the proposed tightenings would affect relatively few LTCs.

98. The main submission points raised on the LTC eligibility criteria included general disagreement with the proposed tightening in the way that trustees and beneficiaries are counted when determining their eligibility as LTC owners, and the associated proposed preclusion of charities and Māori authorities from being LTC owners.

99. In the view of submitters, the tightening was driven by officials’ concerns over situations that were unlikely, or were at the margin, but would impose additional compliance costs on a far wider group of LTCs and could increase the likelihood of inadvertent loss of LTC status.

100. Submitters agreed with the proposal to allow LTCs to have more than one class of shares and the removal, for most LTCs, of the deduction limitation rule. Submitters had mixed views on whether there should be a restriction on the use of LTCs as a conduit vehicle for international investment. Some suggested that this issue was better considered as part of the work on Base Erosion and Profit Shifting (BEPS) or that better disclosure requirements could be used instead of the proposed threshold. There were also technical comments on the design of the threshold.

101. With regard to the proposals around the treatment of debt remission income in the LTC context, submitters were generally supportive.

102. There was mixed support for the proposed changes to the “entry tax” adjustment done at the time a company enters the LTC rules, with some submitters considering the adjustment as unduly punitive given that it requires tax to be paid with no actual distribution taking place.

103. Submitters were in agreement that QCs should be allowed to continue, but there was some debate over the merits of applying a requirement that QC status would be lost upon change of control of the company.

104. The various proposals in relation to RWT and PAYE were generally supported.

105. There was overall strong support for the proposed liberalisation of the tainted capital gains rule. We note that these submissions were on the limited liberalisation proposals recommended in the issues paper. Officials therefore expect that the wider proposal, as recommended under this RIS, will have even wider support.

106. We have taken these comments into consideration in our design of the policy details as discussed in this RIS.

CONCLUSIONS AND RECOMMENDATIONS

107. We note that the majority of the proposals recommended below were suggested in the officials’ issues paper, which contains additional background on the issues and the proposed solutions.

108. Where the proposals have been modified as a result of the submissions received in response to the issues paper, additional comments have been provided to outline officials’ additional considerations.

Rules which impose unnecessary compliance costs

Deduction limitation rule

109. Officials recommend that, except for LTCs that are in partnership or joint ventures, the LTC deduction limitation rule should be removed and previously restricted deductions be released in the 2017/18 year.

110. The removal of the deduction limitation rule is in response to general concern that the rule was not operating correctly, resulted in unnecessary compliance costs for very little effect and was overall unnecessary. This was generally supported by submitters. Instead reliance would be placed on other rules in the Income Tax Act, to preclude excessive deductions, including extending the anti-avoidance rule for partnerships of LTCs.

RWT on dividends between companies

111. Officials recommend the withholding of RWT by a company on a fully imputed dividend paid to another company should be made optional. This proposal reflects the fact that the obligation to withhold RWT on a fully-imputed dividend paid to another company gives rise to unnecessary compliance costs and over-taxation of the dividend.

112. The proposal recommends that the obligation to withhold should be optional in this circumstance. This optionality reflects the fact that for some taxpayers (particularly widely held taxpayers) a requirement to not withhold RWT on fully-imputed dividends may actually raise compliance costs, as they will need to first establish which shareholders are corporates and which are not and also to differentiate between these two groups within their systems.

RWT on concurrent cash and non-cash dividends

113. The proposal recommends that where cash and non-cash dividends are paid contemporaneously they may be regarded as one dividend with respect to the obligation to withhold RWT, so long as the cash component is sufficient to allow for the payment of the RWT on both. This would address the current potential over-taxation of these dividends, and was supported by submitters.

Rules which restrict commercial practice

LTC restriction on share classes

114. Officials recommend that LTC shares be allowed to have more than one class, provided that all shares have uniform entitlements to all distributions. This will allow for legitimate commercial structuring or generational planning without compromising on the simplicity of the income and expenditure attribution. Submitters were widely supportive of this proposal.

Tainted capital gains

115. With regard to the tainted capital gains rule, officials have recommended that the rule's application be restricted to circumstances where indirectly the shareholders of the original owners still own at least 85% of the asset that gave rise to the tainted capital profit. This proposal restricts the scope of the tainting rule significantly compared with the restriction as originally proposed. In response to strong submissions that the proposals in the issues paper did not go far enough, officials did considerable further analysis on the need for the rule.

116. The rule has not been completely repealed, as was recommended by some submitters, because officials consider that it's retention for transactions within a wholly-owned group of companies is appropriate. In particular officials are concerned that repealing the rule would allow, in a wholly-owned group, for companies to realise capital profits and distribute them to shareholders "in lieu of dividends". Officials have concerns over the ability to create "capital profits" which are not real because the asset is still owned by the same shareholder(s) who own the wholly-owned group of companies.

117. The intention is that the revised test would, however, enable the un-tainting of a gain on an asset that has been sold between two wholly-owned group companies when it is subsequently sold outside the group.

Options for taxing shareholder salaries

118. It is recommended that salaries paid to shareholder-employees be able to be bifurcated so that the base salary is subject to PAYE and the variable amount is paid out pre-tax. This proposal will allow for additional flexibility for shareholder-employees who may be unduly constrained by the current rules. In order to ensure that the ability to switch between provisional tax and the PAYE system is not used inappropriately officials recommend that a restriction on flip-flopping is introduced at the same time. The detail of how this restriction will work has not yet been resolved, but we note that interested parties will have an opportunity to provide feedback on this detail as part of the select committee submission process on the bill.

Rules which fail to achieve their intended policy objectives

LTC eligibility criteria

119. With respect to the rules which limit the type of entity that qualifies as a LTC, referred to as the eligibility criteria, broadly officials consider general tightening is necessary to ensure that the rules are appropriately targeted. The transparent tax treatment which applies to LTCs, and in particular the treatment of capital gains earned by the LTC, is a tax favourable treatment that should not be available to more widely held investment vehicles. Many investors in widely held companies are 'passive' in the sense that the alternative to their holding shares in the company would be a bank deposit. In such cases company tax treatment is appropriate as the company distributions are, like interest on bank deposits, taxable in the hands of the shareholders. While there may be debate over whether drawing the boundary between individual and company treatment at five owners is appropriate, data suggests that in practice most closely held businesses have one or two owners which may be because, as noted earlier, close family groups are treated as one owner under the LTC rules.

120. Officials therefore recommend proceeding with the LTC eligibility criteria proposals, with some modifications, and specifically recommend that:

- that the rules for trusts and counted owners be amended to have regard to all trust distributions but using the current 3-4 year measurement period, with a transitional phase-in period;
- that Māori authorities be excluded from owning a LTC, but that present Māori authority LTC arrangements be grand-parented;
- that charities would be excluded from being shareholders in LTCs but would be beneficiaries of trusts shares in LTCs if they have no other interests in the trust except that of being a residual beneficiary in a wind up, or as a genuine beneficiary and the distribution would be regarded as a donation if they were paid by a natural individual;
- that LTC status would be lost if more than 50 per cent of the shareholding in a LTC is held by non-residents and the LTC's foreign income exceeds the greater of \$10,000 and 20 per cent of the LTC's gross income;

121. In response to concerns raised by submitters in relation to the proposed changes for trusts that own LTCs, we note that the proposed changes are unlikely to have great practical effect given the ability to treat close family members as a single owner when calculating the number of counted owners.

122. It should be noted that an additional proposal for extending the time period used for calculating ownership, to reduce the likelihood of rotating beneficiaries, was included in the officials' issues paper, but is now no longer recommended. This aspect is discussed further in Appendix 3.

123. We note that the proposal to preclude charities from owning LTCs has changed from that originally proposed in the officials' issues paper. This is in response to submitters concerns that the proposal would unduly push LTCs owned by trusts with charitable beneficiaries out of the LTC regime, despite the fact that the charitable beneficial ownership is not tax driven. The reason for tightening the rules in relation to charity interests is that charities are in effect widely held entities.

124. Officials now propose that rather than precluding charities from having an interest in a LTC, distributions to charities would be precluded except where the distribution was to a charity that had no influence over the LTC or trust from which they received the distribution. In effect the distribution would meet the key requirement for being a donation that to be a true gift it has to be freely given. The mere existence of a true residual beneficiary capacity should not taint the outcome. This approach would obviate the need for a safe-harbour threshold as originally proposed.

125. Despite submissions raising concerns over the proposal to preclude Māori Authorities from owning LTCs, officials consider the proposal should proceed. As with charities, officials' primary concern around the use of LTCs by Māori Authorities is that Māori Authorities are in effect widely held entities and, therefore, not the target market for LTCs. An alternative look-through vehicle is available under the limited partnership rules, use of limited partnerships in this circumstance is more appropriate as they are designed for more widely held investments.

126. In response to submitters' concerns that the proposals to restrict foreign income for foreign controlled LTCs are targeting behaviour at the margins, officials consider the fact that there may currently be relatively little conduit activity through LTCs does not obviate the need to act now to address the reputational risk, rather than awaiting the wider BEPS work.

127. Submitters also questioned the commerciality of the applicable thresholds. The thresholds are set to reflect the likely LTC target audience. They are intended to provide flexibility for some degree of combined non-resident shareholding and foreign income and should prevent a domestic family business inadvertently falling outside the rules through an owner emigrating.

128. Overall this proposal is not expected to apply to all LTCs that derive foreign income. Officials expect that the majority of LTCs earning foreign income will be predominantly New Zealand owned and, therefore, the rule will not apply. For those LTCs that are currently used by non-residents purely as conduit investment vehicles the proposal is intended to be prohibitive.

LTC entry tax

129. Officials recommend the following changes to the LTC entry tax rules:

- that the income adjustment be modified so that all taxable reserves are deemed to flow through to the owners and are, therefore, taxed at the owners' personal tax rates with imputation credits attached as appropriate;
- that the income adjustment done at the time a QC becomes a LTC be modified so that the owners are taxed only to the extent they would be normally taxed on a liquidation of the QC.

130. The proposal to amend the entry tax formula, to tax the adjustment income at the shareholders' personal tax rates rather than the company rate, is necessary to ensure that the LTC rules are not used to avoid the additional (potential 5%) tax. It supports the integrity of the LTC regime, and the Income Tax Act.

131. The remedial correction to the entry tax adjustment formula for QCs that convert to LTCs is necessary in order to ensure the LTC rules treat QC income consistently with the QC rules.

Debt remission in the LTC context

132. With respect to the debt remission rules, officials recommend the following:

- that remission income no longer arises to a LTC owner who has lent to the LTC and subsequently has remitted the debt, with the change applying retrospectively from the commencement of the LTC rules (this approach should also apply to partners and their partnerships or limited partnerships);
- a technical change to ensure the debt remission rules apply as intended in respect of other situations with the change applying retrospectively from the commencement of the LTC rules.

133. Both of these amendments are necessary to ensure that the debt remission rules operate as intended. In response to submitters concerns, officials recommend that any taxable income that arises as a result of the retrospective application of the second point of the proposal to years before the 2017–18 tax year be recognised prospectively in the 2017–18 tax year. This will minimise the tax consequences for taxpayers who should have had remission income arise in line with the intended operation of the rules, but who took a different tax interpretation.

QC status

134. With respect to existing QCs officials have recommended that their QC status should continue. This recommendation is based primarily on the understanding that there are practical constraints, such as the tax rules on the disposal of a LTC interest, that act as an understandable impediment to their conversion. To force all QCs to convert into ordinary companies or LTCs, by repealing the QC rules would result in significant costs for the owners of the remaining 70,000 QCs.

135. The proposal to restrict a change in control of the existing QCs is required in order to prevent QC trading and thereby ensure that the grandparented entities do not receive a permanent tax advantage. Officials have refined this proposal, in line with submissions, to ensure that property relationship changes and shareholder deaths are ignored when measuring a change of control.

136. Further, to ease compliance, officials have recommended that the change in control test should only apply prospectively, to changes in shareholding from the date of enactment.

IMPLEMENTATION

137. If approved, the preferred options will primarily require changes to the Income Tax Act 2007.

138. Officials recommend any legislative changes be included in the taxation bill scheduled for introduction in March 2016 and apply, unless otherwise stated, from the commencement of the 2017–18 income year.

139. When introduced into Parliament, a commentary on the bill will be released explaining the amendments and further explanation of their effect will be contained in Inland Revenue's Tax Information Bulletin, which would be released shortly after the bill receives Royal assent.

140. Inland Revenue will administer the proposed changes. Enforcement of the changes would be managed by Inland Revenue as business as usual.

MONITORING, EVALUATION AND REVIEW

141. In general, Inland Revenue monitoring, evaluation and review of these proposals would take place under the generic tax policy process (GTPP). The GTPP is a multi-stage policy process that has been used to design tax policy (and subsequently social policy administered by Inland Revenue) in New Zealand since 1995.

142. The final step in the process is the implementation and review stage, which involves post-implementation review of legislation and the identification of remedial issues. Opportunities for external consultation are built into this stage. In practice, any changes identified as necessary would be added to the tax policy work programme, and proposals would go through the GTPP.

Appendix 1: Analysis of options

Issue	Options	Benefits	Costs/Risks
<i>Theme</i>	<i>Rules which impose unnecessary compliance costs</i>		
<p>The deduction limitation rule:</p> <p>This rule restricts a look-through owner’s ability to claim LTC deductions in excess of the money they have invested in the business. Is the rule necessary?</p>	<p>Option 1: Repeal the rule – entirely.</p>	<p>Completely reduces compliance costs, as the rule no longer exists.</p>	<p>Creates potential for avoidance of the deduction limitation rule which applies to limited partnerships, which are structural substitutes for groups of LTCs acting together.</p> <p>Limited partnerships and their close substitutes are considered to be the areas of highest risk of excessive deductions.</p> <p>Requires legislative changes.</p> <p>Gives rise to a fiscal cost of \$17m in the 2017-18 year. This is due to the fact that deductions will no longer be restricted and can be offset against owners’ other income.</p>
	<p>Option 2: Repeal the rule except for LTCs operating in partnership or joint venture with other LTCs, and make some technical clarifications to the rule for those still covered by it.</p>	<p>Reduces the compliance costs associated with compliance for the majority of LTCs.</p> <p>Supports the integrity of the deduction-limitation rule which applies to limited partnerships, which are structural substitutes for groups of LTCs acting together.</p>	<p>Does not remove compliance costs for the small number of LTCs which are acting together in partnership or joint venture with other LTCs. But there are close substitutes for limited partnerships which are subject to an equivalent rule.</p> <p>Requires legislative changes.</p> <p>Fiscal costs same as option 1.</p>

Issue	Options	Benefits	Costs/Risks
	<p>Option 3: Maintain the rule but make some technical clarifications to the rule for those still covered by it.</p>	<p>Addresses some concerns over unintended outcomes. Though officials suspect that, it would not be possible to perfect the rule without introducing significant complexity.</p> <p>Reduces some uncertainty at the margin where the technical errors applied.</p>	<p>Does not relieve the compliance costs as the rule would still need to be applied by all LTCs.</p> <p>Requires legislative changes.</p> <p>May give rise to a fiscal cost. This proposal has not been fully forecasted as the implications would depend on how the technical issues are resolved. Overall we would expect the fiscal cost to be less so than for option 2.</p>
	<p>Option 4: Maintain the status quo.</p>	<p>Does not give rise to a fiscal cost.</p> <p>No legislative change is required.</p>	<p>Does not reduce compliance costs.</p> <p>Would not resolve concerns over technical errors in the rule.</p>
<p>The deduction limitation rule:</p> <p>If the rule is amended or repealed, what should happen to previously restricted deductions?</p>	<p>Option 1: Repeal the rule in part (refer option 2 above) and release previously restricted deductions in one lump at a particular point.</p>	<p>Allows for quick use of previously restricted deductions.</p> <p>Avoids the compliance and administrative costs associated with re-stating past periods.</p>	<p>Does not address the tax impact of having deferred the deductions in the interim for the few owners (around 1%) that have suspended deductions.</p> <p>Requires legislative changes.</p> <p>Gives rise to a fiscal cost of \$17m in the 2017-18 year. This is due to the fact that deductions will no longer be restricted and can be offset against owners' other income.</p>
	<p>Option 2: Repeal the rule in part (refer option 2 above) and require restatement of prior period returns on the basis that the rule had not existed.</p>	<p>Allows for the recognition of previously restricted deductions.</p> <p>Addresses the tax impact of having deferred the deductions in the interim for the few owners (around 1%) that have suspended deductions.</p>	<p>The need to re-state past periods increases compliance and administrative costs. Overall, the increased administrative and compliance costs are unlikely to outweigh the benefits to the few owners (around 1%) that have suspended deductions. In other words, the economic costs are likely to outweigh the economic benefits.</p> <p>Requires legislative changes.</p> <p>Fiscal cost, as per option 1 above, except the 2017-18 cost would be spread retrospectively across past periods.</p>

Issue	Options	Benefits	Costs/Risks
	<p>Option 3: Repeal the rule in part (refer option 2 above) and gradually release previously restricted deductions over three years.</p>	<p>Spreads the fiscal cost.</p> <p>Does not create additional compliance and administrative costs incurred in re-stating past periods.</p> <p>For some, may not be much different than full release in 2017/18, when there is insufficient other income to apply deductions against.</p>	<p>Requires legislative changes.</p> <p>Minor additional compliance and administration costs relative to full release of deductions in 2017/18.</p> <p>Delays utilisation of deductions that have been effectively freed-up.</p> <p>Gives rise to a fiscal cost, as per option 1 above except the effect may be spread across three periods.</p>
<p>Dividend rules: RWT on dividends between companies</p> <p>Should the RWT obligation to withhold 5% on fully-imputed dividends paid between all companies be removed?</p>	<p>Option 1: The obligation to account for RWT on all fully-imputed dividends paid between companies should be removed.</p>	<p>Eliminates the current over-taxation of dividends paid between companies.</p> <p>Reduces compliance costs for some companies that pay fully-imputed dividends to other companies.</p>	<p>Potential increase in compliance costs for paying companies, by requiring them to:</p> <ul style="list-style-type: none"> • establish whether or not shareholders are corporate (which can be difficult for widely held companies); and • differentiate between corporate and non-corporate recipients in their systems (i.e. in order to ensure RWT is withheld only on dividends to non-corporate). <p>Requires legislative changes.</p> <p>Fiscal cost of \$9m in first year of operation.</p>
	<p>Option 2: The obligation to account for RWT on all fully-imputed dividends paid between companies should be optional.</p>	<p>Alleviates the current over-taxation of dividends paid between companies.</p> <p>Reduces compliance costs for all companies that choose to not account for the RWT and does not increase compliance costs for other companies who cannot or choose not to identify which shareholders are corporate.</p>	<p>Requires legislative changes.</p> <p>Fiscal cost same as option 1.</p>

Issue	Options	Benefits	Costs/Risks
	<p>Option 3: The obligation to account for RWT on all fully-imputed dividends paid between companies should be maintained (status quo).</p>	<p>No fiscal implications.</p> <p>Does not require paying companies to establish which shareholders are corporate and/or differentiate between corporate and non-corporate recipients.</p> <p>No legislative change is required.</p>	<p>Does not eliminate nor alleviate the current over-taxation of dividends paid between companies.</p> <p>Does not reduce compliance costs associated with the obligation to withhold RWT on fully-imputed dividends paid between companies.</p>
<p>Dividend rules: RWT on concurrent cash and non-cash dividends</p> <p>Should a company paying cash and a non-cash dividends concurrently, be able to opt to treat the two dividends as a single dividend, for the purposes of the RWT obligations when the cash dividend is sufficient to cover the RWT due?</p>	<p>Option 1: A taxpayer should be able to opt to treat cash and non-cash dividends paid concurrently as a single dividend, when the cash dividend is sufficient to cover the RWT obligations for both dividends.</p>	<p>Addresses the concern that the current rule over-taxes the non-cash dividend (as a result of the gross up requirement) in these circumstances.</p> <p>Reduces the compliance and administrative costs associated with the refund of the over-taxation.</p> <p>Does not affect the RWT payment, as the RWT due on both dividends is covered in the cash dividend.</p>	<p>Requires legislative changes.</p>
	<p>Option 2: A taxpayer should not be able to opt to treat cash and non-cash dividends paid concurrently as a single dividend, with the two dividends remaining separate for the purposes of the RWT obligations (status quo).</p>	<p>No legislative change is required.</p>	<p>Does not address the concern that the current rule over-taxes the non-cash dividend (as a result of the gross up requirement) which may then require a refund if credit cannot be used against the tax liability on other income.</p>

Issue	Options	Benefits	Costs/Risks
<i>Theme</i>	<i>Rules which restrict commercial practice</i>		
<p>LTC restriction on share classes</p> <p>Should LTCs be allowed to have more than one class of shares?</p>	<p>Option 1: LTCs should have the option of having more than one share class.</p>	<p>Allows for flexibility in succession planning and acceptable corporate structuring.</p> <p>Remove the need for share class restructuring for companies that have existing share class differentiation and therefore cannot elect into the LTC regime currently. This would also remove what officials consider may be a deterrent to more grandparented QCs transitioning to LTCs.</p>	<p>Requires legislative changes.</p> <p>Compromises on the simplicity of income/expenditure attribution from the LTC, by allowing for differentiation in share class entitlements to income/expenditure, which may lead to more compliance costs.</p>
	<p>Option 2: A LTC should be able to have more than one class of shares provided all shares still have uniform entitlements to distributions from the LTC (i.e. differentiate on voting rights only).</p>	<p>Allows for better flexibility in succession planning and acceptable corporate structuring, without compromising on the simplicity of income/expenditure attribution from the LTC.</p> <p>Goes some way towards removing the need for share class restructuring in companies wanting to elect into the LTC regime (to the extent that the differentiation is only related to voting rights) including grandparented QCs transitioning to LTCs.</p>	<p>Requires legislative changes.</p> <p>For companies whose classes of shares differ for more than just voting rights, this option would not be of benefit.</p>
	<p>Option 3: LTCs should continue to be restricted to having just one share class (status quo).</p>	<p>No legislative change is required.</p>	<p>Does not allow for flexibility in succession planning and acceptable corporate structuring.</p> <p>Does not allow for companies that have existing share class differentiation to elect into the LTC regime, which may therefore continue to be a deterrent to more grandparented QCs transitioning to LTCs.</p>

Issue	Options	Benefits	Costs/Risks
<p>Tainted capital gains rule:</p> <p>Should the rule be repealed?</p>	<p>Option 1: Repeal the rule.</p>	<p>Removes the overreach imposed by the current rule.</p> <p>Facilitates corporate restructuring.</p>	<p>Requires legislative changes.</p> <p>Removes the protection that the current rule provides against non-market transactions (for example intra-group sales used to inflate capital profits or dividend strips to transfer cash from one company to another) and the other tax rules, which could apply, are considered to not offer sufficient alternative protection in these cases.</p> <p>Freeing up corporate restructuring may encourage tax driven structuring, which is undesirable.</p>
	<p>Option 2: Restrict the rules to apply only to the wholly-owned group context.</p>	<p>Addresses some of the overreach imposed by the current rule.</p> <p>Facilitates some corporate restructuring, (i.e. not in the wholly-owned group situation).</p> <p>Preserves the protection that the current rule provides against non-market transactions (for example intra-group sales used to inflate capital profits or dividend strips to transfer cash from one company to another) which are more likely in the wholly-owned group context.</p>	<p>Requires legislative changes.</p> <p>Freeing up corporate restructuring (outside of wholly-owned group) may still encourage tax driven structuring, which is undesirable.</p> <p>Removes the protection provided by the current rule against non-market transactions outside of wholly-owned groups.</p>
	<p>Option 3: Restrict the rules to apply only to the wholly owned group context and to sales of assets where less than 15% of the asset has been sold to a third party (i.e. 85% of the asset is held by the original owners).</p>	<p>Addresses some of the overreach imposed by the current rule.</p> <p>Facilitates some corporate restructuring, (outside of the wholly-owned group circumstance, and when asset ownership has not changed by more than 15%).</p> <p>Provides scope for trading of assets between associates.</p> <p>Bolsters other tax rules by providing protection against non-market transactions and payments in lieu of dividends through material third party involvement (15%) bolsters other tax rules.</p> <p>Provides certainty with the bright-line 15% threshold.</p>	<p>Requires legislative changes.</p> <p>May still encourage tax driven structuring, which is undesirable. The requirement for a 15% change in ownership of the underlying asset provides some comfort that the price paid for the asset is genuine (i.e. limits the ability to generate inflated gains even outside of the wholly-owned group context).</p> <p>The 15% threshold might be considered arbitrary.</p>

Issue	Options	Benefits	Costs/Risks
	Option 4: Do not repeal the rule (status quo).	No legislative change is required.	<p>Does not address the concern that the current rule has overreach, and can taint genuine gains made on transfers to associates.</p> <p>Does not address the concern that the current rule unduly restricts legitimate commercial restructuring.</p>
<p>Options for taxing shareholder salaries:</p> <p>Should shareholder salaries for shareholder-employees who do not receive regular amounts or do not get paid in regular periods, be subject to PAYE, provisional tax or a mix of both?</p>	<p>Option 1: Shareholder employees should be able to choose between a mix of PAYE and provisional tax on their salaries, and the choice of method is unrestricted period to period.</p>	<p>Allows for flexibility in taxation approach, to reflect a shareholder-employee’s individual circumstances. This can lead to reduced compliance costs for both employee and employer (by not requiring shareholder employees to structure their arrangements around the tax consequences).</p> <p>Is an optional proposal, therefore, it will not result in any additional compliance costs for taxpayers who do not wish to use this option.</p>	<p>Would allow flip-flopping between methods from year to year which may allow manipulation of provisional tax requirements and may lead to additional compliance costs for employees and their employers. However as this is an optional proposal, this additional cost will only arise for taxpayers who choose to apply the mixed methods.</p> <p>Requires legislative changes.</p>
	<p>Option 2: Shareholder employees should be able to choose between a mix of PAYE and provisional tax on their salaries, and the choice of method is restricted period to period to prevent flip-flopping between methods in succeeding periods.</p>	<p>Allows for flexibility in taxation approach, to reflect a shareholder-employee’s individual circumstances which can lead to reduced compliance costs for both employee and employer.</p> <p>Is an optional proposal, therefore, will not result in any additional compliance costs for taxpayers who do not wish to use this option.</p> <p>Would prevent potential manipulation of provisional tax liabilities that might arise from flip-flopping between PAYE and provisional tax.</p>	<p>Changes between methods may lead to additional compliance costs as employees and their employers adjust to the change.</p> <p>However as this additional cost will only arise for taxpayers who choose to apply the mixed methods.</p> <p>Requires legislative changes.</p>
	<p>Option 3: Shareholder salaries should be subject to either PAYE or provisional tax, but not both (status quo).</p>	<p>Applying only one approach to taxation of income, can simplify compliance for the employer.</p> <p>No legislative change is required.</p>	<p>Does not allow for flexibility in taxation approach, which can lead to additional compliance costs (by forcing shareholder employees to structure their arrangements around the tax consequences) for both employee and employer.</p>

Issue	Options	Benefits	Costs/Risks
<i>Theme</i>	<i>Rules which fail to achieve their intended policy objectives</i>		
<p>LTC eligibility criteria: LTCs owned by trusts</p> <p>For LTCs owned by trusts is the integrity of the ‘look-through counted owner’ limitation undermined by the application of the rule to distributions of beneficiary income only?</p>	<p>Option 1: Extend the ‘look-through counted owners’ test to include all beneficiaries who receive any distributions (whether as beneficiary income or trustee income, corpus or capital) from LTC shareholding trusts.</p>	<p>Supports the integrity of the rules by:</p> <ul style="list-style-type: none"> • including all ‘look-through owners’ who benefit economically from the LTC ownership; • recognising the fungibility of money; and • preventing the streaming of certain types of income to selected beneficiaries. <p>Is not expected to disproportionately disadvantage current structures or induce tax driven behavioural changes because of the fact that the majority of LTCs currently have only one or two counted owners (assisted by the ability to treat close relatives as a single owner).</p>	<p>Potential to lead to some additional compliance costs for trustees given the need to keep accurate records of all distributions not just beneficiary income distributions.</p> <p>Potentially increases risk of inadvertent breach by trustees who are not careful to count all distributions of trust income, corpus or capital. However we note that this is not a material risk for family trusts which make up a high proportion of all trusts.</p> <p>This risk can also be ameliorated in the first instance by providing a transitional period.</p> <p>Requires legislative changes.</p>
	<p>Option 2: Remain with status quo, and count only distributions of beneficiary income from LTC interests.</p>	<p>No increase in compliance costs.</p> <p>No increase in risk of inadvertent breach.</p>	<p>Fails to recognise the reality that a person who does not receive beneficiary income can nevertheless benefit from a trust owning LTC shares.</p> <p>Improves the integrity of the eligibility criteria as could effectively allow for more than 5 LTC owners.</p> <p>Requires legislative changes.</p>
<p>LTC eligibility criteria: LTCs owned by corporates</p> <p>Should trusts that own LTCs be allowed to have corporate beneficiaries, given that direct ownership of a LTC by a corporate (non-LTC) is prohibited?</p>	<p>Option 1: Trusts that own LTCs should not be allowed to have corporate beneficiaries.</p>	<p>Supports the integrity of the prohibition on corporate ownership of LTCs.</p> <p>Reinforces the objective of ensuring that LTCs are not able to be widely held.</p>	<p>This would result in many LTCs failing the eligibility criteria, as many LTCs are owned by trusts which have corporate beneficiaries.</p> <p>Would result in some restructuring, for LTCs owned by trusts with corporate beneficiaries, which may result in additional compliance costs (incurred in the restructure) and/or tax costs (incurred due to the consequences of LTC share disposal).</p> <p>Requires legislative changes.</p>

Issue	Options	Benefits	Costs/Risks
	<p>Option 2: Trusts that own LTCs should be allowed to have corporate beneficiaries so long as no distributions are made to those corporate beneficiaries.</p>	<p>Supports the integrity of the prohibition on corporate ownership of LTCs by restricting the economic benefits of LTC ownership from flowing through to corporate beneficiaries.</p> <p>Does not result in restructuring of existing structures, as corporate beneficiaries in and of themselves do not cause the LTC to fail the eligibility criteria, so long as no distributions are made to those beneficiaries.</p>	<p>By not allowing for any distributions to corporate beneficiaries, including ones where the total number of counted owners (including all shareholders of the corporate beneficiary) is below 5, this proposal would preclude distribution to those corporates that meet the LTC requirements but who have not elected into the LTC rules. Currently such distributions are allowed.</p> <p>It will result in some trusts incurring costs in restructuring to remove corporate beneficiaries and/or tax costs (incurred due to the consequences of LTC share disposal).</p> <p>Requires legislative changes.</p>
	<p>Option 3: Trusts that own LTCs should be allowed to have corporate beneficiaries.</p>	<p>Allows for broader use of the LTC regime.</p> <p>Has no effect on existing or future structures.</p>	<p>Undermines the policy intent that LTCs should not be widely held vehicles.</p> <p>Poses a risk to the tax base by encouraging planning opportunities involving corporates.</p> <p>Requires legislative changes.</p>
	<p>Option 4: Trusts that own LTCs should be allowed to have corporate beneficiaries, only if the total number of counted owners (including all shareholders of the corporate beneficiary) remains below 5(status quo).</p>	<p>Has no effect on existing or future structures as is current requirement.</p> <p>No legislative change is required.</p> <p>Partly meets objective of LTCs not being able to be widely held.</p>	<p>The integrity of the prohibition on corporate ownership of LTCs continues to be undermined.</p> <p>Only partly meets objective of ensuring LTCs are not able to be widely held.</p>

Issue	Options	Benefits	Costs/Risks
<p>Eligibility criteria: LTCs owned by charities</p> <p>Should a charity be precluded from owning a LTC (which is ordinarily reserved for closely held businesses) either directly or indirectly (as a beneficiary of a trust) because a charity typically has a wide pool of beneficiaries?</p>	<p>Option 1: Charities are precluded from owning LTCs directly or indirectly.</p>	<p>Achieves the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries.</p>	<p>This may discourage donations, which is contrary to Government policy.</p> <p>This would result in many LTCs failing the eligibility criteria, as many LTCs are owned by family trusts which commonly have residual charitable beneficiaries.</p> <p>This could lead to increased compliance costs (incurred in the restructure) and/or tax costs (incurred due to the consequences of LTC share disposal) as taxpayers restructure to ensure LTC eligibility is maintained (for example by settling a separate LTC owning trust).</p> <p>Requires legislative changes.</p>
	<p>Option 2: Charities are precluded from owning LTCs either directly or indirectly, but are allowed to make charitable distributions (capped at 10 % of net LTC income received by the trust in the year).</p>	<p>Assists the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries, by strengthening the rule.</p> <p>Allows for some charitable donations.</p>	<p>The 10% threshold is arbitrary and may discourage large donations, which is contrary to Government policy.</p> <p>This would result in many LTCs failing the eligibility criteria, as many LTCs are owned by family trusts which commonly have residual charitable beneficiaries which would lead to additional compliance costs (incurred in the restructure) and/or tax costs (incurred due to the consequences of LTC share disposal).</p> <p>Requires legislative changes.</p>

Issue	Options	Benefits	Costs/Risks
	<p>Option 3: Charities are precluded from owning LTCs directly, but not precluded from indirectly benefiting from the LTC as either residual beneficiary of a LTC owning trust, or ordinary beneficiaries when the charity has no influence over the LTC or trust (in effect any distribution is a true gift which is freely given).</p>	<p>Assists the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries, by strengthening the rule.</p> <p>Allows for unlimited (genuine) charitable donations.</p> <p>Does not force many LTCs out of the regime (by failing the eligibility criteria), by allowing residual charitable beneficiaries.</p> <p>Would not necessitate extensive restructuring, (based on submissions received the majority of LTCs have only got charitable owners as beneficiaries of owning trusts).</p>	<p>Would result in some restructuring, for charities which own LTCs directly, which would lead to additional compliance costs.</p> <p>Requires legislative changes.</p>
	<p>Option 4: Charities should be able to own LTC interests (status quo).</p>	<p>Allows for unlimited charitable donations.</p> <p>Has no effect on existing structures.</p> <p>No legislative change is required.</p>	<p>Does not achieve the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries.</p> <p>May encourage more charities to use LTCs.</p>
<p>Eligibility criteria: LTCs owned by Māori Authority</p> <p>Should a Māori Authority be precluded from owning a LTC (which is ordinarily reserved for closely held businesses) either directly or indirectly (as a beneficiary of a trust) because a Māori Authority typically has a wide pool of beneficiaries?</p>	<p>Option 1: Māori Authorities are precluded from owning LTCs directly or indirectly.</p>	<p>Achieves the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries.</p> <p>To achieve equivalent transparent tax treatment, Māori Authorities would have to use limited partnerships, which are intended for use as widely held investment vehicles.</p>	<p>For Māori Authorities which currently own LTCs directly, this proposal would result in restructuring their separate business operation to either:</p> <ul style="list-style-type: none"> • an alternative look-through vehicle to achieve the same outcome, which may result in compliance cost; or • to a standard company in which case there will be situations in which excess imputation credits cannot be readily utilised. <p>Requires legislative changes.</p>

Issue	Options	Benefits	Costs/Risks
	<p>Option 2: Māori Authorities are precluded from owning LTCs directly or indirectly, but existing structures are grand-parented.</p>	<p>Achieves the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries.</p> <p>Saves Māori Authorities the cost of restructuring their current LTC interests.</p>	<p>May provide Māori Authorities which currently own LTCs with some small advantage (through lower on-going operational costs) over Māori Authorities which do not currently own LTCs.</p> <p>Requires legislative changes.</p>
	<p>Option 3: Māori Authorities are not precluded from owning LTCs directly or indirectly (status quo).</p>	<p>Has no effect on existing or future structures.</p> <p>No legislative change is required.</p>	<p>Does not achieve the goal of ensuring that LTCs are not able to be held by what is effectively a wide pool of beneficiaries.</p>
<p>Eligibility criteria: International aspects</p> <p>How should the use of LTCs as conduit investment vehicles (i.e. foreign investors earning foreign income through the LTC) be limited?</p>	<p>Option 1: Foreign owners should not be able to own LTCs at all.</p>	<p>Addresses the reputational risk posed by the use of LTCs as conduit investment vehicles.</p>	<p>Restricts inbound investment into New Zealand through LTCs entirely, not just in the conduit circumstance.</p> <p>This would result in many LTCs failing the eligibility criteria, as many LTCs are in some part foreign owned, which would lead to additional compliance costs (incurred in restructuring affairs) and/or tax costs (incurred due to the consequences of LTC share disposal).</p> <p>Would result in LTC status being lost where a resident becomes a non-resident for tax purposes.</p> <p>Requires legislative changes.</p>

Issue	Options	Benefits	Costs/Risks
	Options 2: Foreign owners should be able to own LTCs but not earn any foreign income.	<p>Addresses the reputational risk posed by the use of LTCs as conduit investment vehicles.</p> <p>Best aligns with the intended use of LTCs as domestically focussed investment vehicles.</p>	<p>Restricts outbound investment by all LTCs, not just in the conduit circumstance.</p> <p>This would result in many existing LTCs failing the test unless owners can easily dispose of foreign investments, which would lead to additional costs in restructuring affairs and/or tax costs through the disposal of LTCs shares).</p> <p>Requires legislative changes.</p>
	Option 3: Foreign owners should be able to own LTCs, but LTCs that are foreign controlled (i.e. 50% foreign owned) should only be able to earn a limited amount of foreign income.	<p>Addresses the reputational risk posed by the use of LTCs as conduit investment vehicles.</p> <p>Does not overly restrict inbound investment (by not restricting foreign ownership of LTCs), or outbound investment.</p> <p>Ensures LTC use is better aligned with their intended use as primarily domestically focussed investment vehicles.</p>	<p>Introducing foreign income restrictions and foreign ownership restrictions can increase compliance costs as LTC owners need to check/ensure compliance. However we note that the application of the proposal is limited to foreign controlled LTCs, which is likely to be very few.</p> <p>Requires legislative changes.</p>
	Option 4: Foreign ownership of LTCs should not be restricted and the ability to earn foreign income should not be restricted (status quo).	<p>Has no effect on existing or future structures.</p> <p>Does not restrict inbound or outbound investment.</p> <p>No legislative change is required.</p>	<p>Does not address the reputational risks posed by the use of LTCs as conduit investment vehicles.</p>

Issue	Options	Benefits	Costs/Risks
<p>LTC entry tax</p> <p>Should the entry tax formula be amended to change the tax rate that applies to any income calculated by the adjustment?</p>	<p>Option 1: The entry tax formula should be amended to change the tax rate that applies to any income calculated by the adjustment, to the LTC shareholder's personal tax rates.</p>	<p>Promotes equity by addressing the tax advantage which is currently only available to shareholders whose personal tax rate exceeds 28% (those on the 30% or 33% marginal tax rate). Equally addresses the tax disadvantage for shareholders with personal tax rates below 28%.</p> <p>Creates certainty and reduces enforcement costs, by preventing the potential for avoidance of tax by cashed up companies who elect into the LTC regime and then subsequently liquidate.</p> <p>Gives rise to a small fiscal gain.</p>	<p>Requires legislative changes.</p>
	<p>Option 2: The entry tax formula should not be amended to change the tax rate that applies to any income calculated by the adjustment (status quo).</p>	<p>No legislative change is required.</p>	<p>Does not address the potential over or under-taxation of shareholders (depending on their personal tax rates) which the current formula causes.</p> <p>Does not resolve uncertainty over when a company that elects into the LTC regime and then subsequently liquidates, will be challenged on tax avoidance grounds.</p> <p>Does not reduce enforcement costs associated with disputes on whether a company that elects into the LTC regime and then subsequently liquidates is guilty of tax avoidance.</p>
<p>Debt remission in LTC context:</p> <p>When a shareholder loans money to their LTC and the debt is subsequently forgiven; should debt remission income</p>	<p>Option 1: Debt remission income should not arise for the shareholder-creditor when the debt is forgiven.</p>	<p>Addresses the current over-taxation in the hands of the owner who remitted the debt.</p> <p>Is conceptually more sound than allowing the bad debt deduction, given that the deduction represents a capital loss.</p>	<p>Requires legislative changes.</p>

Issue	Options	Benefits	Costs/Risks
<p>arise for the shareholder-creditor?</p>	<p>Option 2: Debt remission income should arise for the shareholder-creditor when the debt is forgiven, but they should get a bad debt deduction to offset the income.</p>	<p>Addresses the current over-taxation in the hands of the owner who remitted the debt, by allowing the deduction.</p>	<p>Requires legislative changes. In particular this changes the approach from the more general debt remission project which addresses the remission income. Any change in approach would be counter-productive and confusing.</p> <p>Conceptually this proposal purports to give the shareholder-creditor a deduction for what is in reality a capital loss. Bad debt deductions are usually limited to debts held on revenue account. This proposal therefore diverges from the capital/revenue boundary in this context.</p> <p>The deduction would have to be limited to the amount of remission income assigned to the shareholder-creditor as otherwise they would get recognition of the full economic loss for the debt which would not match the transfer to the other LTC owners (that is despite the fact that the other owners would be taxed on the transfer as debt remission income).</p>
	<p>Option 3: Debt remission income should arise for the shareholder-creditor when the debt is forgiven, and they should not get a bad debt deduction to offset the income (status quo).</p>	<p>No legislative change is required.</p>	<p>Does not address the current over-taxation in the hands of the owner who remitted the debt.</p> <p>Does not allow a deduction for the economic loss to the shareholder-creditor.</p>
<p>QC Status:</p> <p>Should all grandparented QCs be repealed?</p>	<p>Option 1: Repeal all QCs.</p>	<p>Limits the number of available vehicles for closely held companies, which minimises the potential for tax driven structuring.</p> <p>Addresses the concern that existing QCs may have a permanent tax advantage when compared to non-QCs.</p>	<p>Requires legislative changes.</p> <p>Would give rise to significant compliance costs for QCs that would have to convert to either LTCs or ordinary companies.</p>

Issue	Options	Benefits	Costs/Risks
	<p>Option 2: Maintain grandparenting but allow remaining QCs to continue (status quo).</p>	<p>No legislative change is required.</p> <p>Does not impose additional compliance costs by forcing conversion of current QCs.</p>	<p>Does not address the concern that existing QCs may have a permanent tax advantage when compared to non-QCs.</p> <p>Allows for trading of QCs which undermines Parliament's intention to grandparent the regime.</p>
	<p>Option 3: Allow remaining QCs to continue but QC status would be lost on the sale of any QC shares to new owners.</p>	<p>Limits the life of the QC regime to the business span of existing QCs.</p> <p>Prohibits any trading of QCs which supports Parliament's intention to grandparent the regime.</p> <p>Eliminates the potential for tax driven structuring with respect to existing QCs.</p> <p>Addresses the concern that existing QCs may have a permanent tax advantage when compared to non-QCs, by making the tax advantage available only to existing QC owners.</p> <p>Does not impose additional compliance costs by forcing conversion of current QCs.</p>	<p>Requires legislative changes.</p> <p>Does not allow for any commercial restructuring (which may not necessarily be tax driven).</p> <p>Increases risk that a QC may inadvertently lose status upon the 'transfer' of a single share.</p> <p>Should exclude share transfers as a result of a relationship property settlement or death of a shareholder.</p>
	<p>Option 4: Allow remaining QCs to continue but QC status would be lost if sufficient shares are sold so that there has been a change of control.</p>	<p>Prohibits any trading of QCs which supports Parliament's intention to grandparent the regime.</p> <p>Minimises the potential for tax driven structuring with respect to existing QCs, while allowing for some commercial restructuring (which may not necessarily be tax driven).</p> <p>Addresses the concern that existing QCs may have a permanent tax advantage when compared to non-QCs, by making the tax advantage available primarily to existing QC owners.</p> <p>Does not create a risk of inadvertent loss of QC status, as it requires a significant change.</p> <p>Does not impose additional compliance costs by forcing conversion of current QCs.</p>	<p>Requires legislative changes.</p> <p>Should exclude share transfers as a result of a relationship property settlement or death of a shareholder.</p>

Appendix 2: Analysis of remedial issues identified for amendment

Keyword	Issue	Proposal	Comments	Nature of proposal
QCs and LTC entry tax	The QC rules allow for tax free distribution of capital gains and other un-imputed earnings, which are treated as exempt dividends when distributed to QC shareholders. The entry tax formula will apply to tax all un-imputed retained earnings except eligible capital profits, which for QCs which elect into the LTC rules means that tax is incorrectly overcharged to the extent that the earnings are not eligible capital profits.	Officials recommend that the adjustment formula is amended to ensure that QCs electing into the LTC regime do not get overtaxed. This would mean that reserves that are would be untaxed if distributed prior to conversion, are untaxed on conversion under the entry formula.	This technical error may be discouraging some QCs from converting to LTCs. Fixing this error may therefore result in more QCs converting to LTCs.	Technical
Asset value upon LTC entry	There is technical doubt about which asset values to use (cost/market value/something else) when a company elects into the LTC regime.	Officials recommend that the law be clarified so that the tax book value of assets and liabilities of a company that elects into the LTC regime are the opening tax book values for the LTC. This amendment should be made retrospective to the commencement of the LTC regime (that is, from the commencement of the 2011–12 tax year).	The policy intent is that the company's tax book values roll over into the LTC, and the LTC election tax is calculated on this basis. Officials are not aware of any taxpayer that has not used tax book values. However, this is not made clear in the legislation.	Remedial
Backdated dividends and shareholder current accounts	There is a concessionary rule which enables dividends to be paid to shareholders to clear their overdrawn current accounts with their dividends being regarded as being paid on the 1st day of an income year so long as the dividend is fully tax paid (that is RWT does not need to be deducted). However, due to the company tax rate being decreased, all dividends incur at least 5%RWT and the concessional backdating cannot apply.	Officials recommend that the rule is amended to allow dividends that are fully imputed (to 28%) to qualify for back dating to the 1st day of the income year, for shareholder current account purposes.	Anecdotally, taxpayers appear to observing this rule in the breach when the dividend is fully imputed.	Remedial

Keyword	Issue	Proposal	Comments	Nature of proposal
Debt remission upon exit from LTC regime or liquidation	When a LTC elects out of the regime or enters liquidation, the LTC is deemed to have disposed of all of its financial arrangements at market value and there should be debt remission income on any unpaid third party debt. The LTC legislation that governs LTCs liquidating or exiting the LTC regime (treated as a deemed liquidation) is not sufficiently clear and in insolvency situations where the remission of third party debt is likely to happen, some LTC owners are not returning the debt remission income as was contemplated.	Officials recommend that a retrospective amendment is made to ensure that the debt remission income rules apply as intended. This would mean that remission income should arise for LTC owners when they either liquidate or elect to take their company out of the LTC rules.	<p>This is a technical change, as remission income was always intended to arise. The issue is around the market value of any impaired third party loans at the time of disposal, with some practitioners arguing that the market value of a loan, distressed or not, is the present value of its future cash flows without considering its distressed impairment. This approach ignores the risk associated with the loan.</p> <p>Ensuring, that the debt remission rules work as intended is particularly important if, as recommended the deduction limitation rule is largely removed.</p> <p>This proposal is expected to be fiscally positive. The retrospective application of the rule may mean that taxpayers who did not apply the rule as intended may have tax due on amounts remitted from the 2011-12 onwards. To ease compliance and to limit the adverse tax consequences for these taxpayers (for example exposure to UOMI, penalties and the need to restate prior periods), officials have recommended that any income arising as a result of the retrospective application of this remedial will be included in the 2018-19 income year.</p>	Remedial

Appendix 3: Analysis of issues not progressed

Proposal	Origin	Decision	Comments
Companies should be able to distribute capital gains tax free during the course of business, not just on liquidation.	Raised by submitters	Proposal to be considered for inclusion in the tax policy work programme.	Officials consider that the wider policy issue of capital gain distributions outside of the LTC and QC context is complex and cannot be looked at purely in isolation as part of the closely held companies review. Further work on this issue would be better handled through the standard tax policy work programme process at some future date.
Close companies should be able to elect out of RWT obligations on dividends and interest, subject to director's guarantee	Discussed by officials in the <i>Closely held company taxation</i> issues paper	Proposal to be considered as part of <i>Making Tax Simpler</i> .	This proposal would give rise to significant fiscal costs resulting from the deferral of tax from one period to the next. Officials consider that this proposal would best be considered in the wider context of the work being undertaken to streamline business tax processes, as discussed in the Government discussion document titled <i>Making Tax Simpler A Green Paper</i> (released in March 2015).
Extend the measurement period when counting beneficiaries who receive LTC income distributions from a trust that owns a LTC	Discussed by officials in the <i>Closely held company taxation</i> issues paper	Proposal should not be progressed.	This was one of two proposals recommended in the issues paper with regard to counting beneficiaries for the purposes of determining the number of LTC owners. Officials were concerned that the current 3-4 year measurement period provided the potential to 'rotate' beneficiaries so as to undermine the 5 or fewer look-through counted owner limitation and suggested extending the measurement period to 6 years, in line with general record keeping requirements. Submissions were concerned that this extension would create undue compliance costs. In response, officials recommend keeping this aspect under review to see if churning proves to be an issue in practice and if need be the matter could be addressed by an anti-avoidance rule.
LTC elections should not be able to be revoked by a single shareholder, and the Commissioner should have more discretion to apply late or incomplete LTC elections retrospectively.	Raised by submitters	Proposals should not be progressed.	Officials consider that given all look-through owners are personally responsible for the tax on the company's business profits, it would not be appropriate to change the rules to restrict an owner's ability to elect out of the regime. The risk of an unintended revocation is addressed both by shareholders having the ability to structure agreements to provide additional protections, as well as by the Commissioner's discretionary power to disregard a revocation notice in circumstances where the owner who made the revocation is subsequently bought out. Further, as all look-through owners are personally responsible for the tax on the company's business profits, officials consider that it would not be appropriate for the Commissioner's current discretionary power to accept late elections and apply them retrospectively, to be extended in the way suggested by the submission.

Proposal	Origin	Decision	Comments
<p>The definition of close company, which refers to companies with five or fewer natural person shareholders, should be clarified to address the concern that at present the definition allegedly excludes companies owned by trusts, which is a common structure for many of New Zealand's small businesses.</p>	<p>Raised by submitters</p>	<p>Proposals should be considered for inclusion in the tax policy work programme as a separately project.</p>	<p>Given the time required to adequately consider the extensive use of the definition in different contexts throughout the legislation, officials have recommended that this issue should be progressed as a separate project. In the meanwhile Inland Revenue is considering issuing further guidance on point.</p>
<p>The extent of LTC transparency should be clarified.</p>	<p>Raised by submitters</p>	<p>Further consideration deferred for the time being.</p>	<p>There is case law on the treatment of partners in partnerships which could assist in the interpretation of the LTC rules which have been modelled on the partnership tax provisions. However, this will not assist for a LTC with a single shareholder. Officials agree that LTC transparency should be an area for further consideration, but consider the issue a low priority given that the key issue, debt remission income, is being addressed.</p>