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Special Corporate Tax Issue
Business Tax Changes

Introduction

This TIB covers the main business tax changes announced in the 1991 Budget and enacted in the Income Tax Amendment Act (No 2) 1992. It is divided into the following parts:

- changes to the treatment and determination of dividends;
- the determination of ownership rules;
- changes to the loss carry forward and grouping rules and changes to the carry forward of credits in imputation credit accounts;
- the introduction of a new tax recovery provision - section 276; and
- the introduction of a qualifying company regime.

The part relating to dividends covers not only technical amendments to the definition but also the consequences of treating cash and non-cash dividends in a similar fashion. Moreover, it discusses the specific temporary exemptions to the general removal of the intercorporate dividend exemption.

The new ownership tests of voting interest and market value interest provide a measure of a person's interest in a company. These interest tests are relevant in a number of regimes, such as the loss carry forward and grouping provisions, imputation credit carry forward provisions, tax recovery, and the qualifying company regime.

The new carry forward and grouping of loss provisions require 49% continuity of shareholding for the carry forward of losses and 66% commonality of shareholding for the grouping of losses. New tracing requirements which should ease compliance concerns considerably are introduced. The credit continuity provisions have also been amended to reflect the aggregation of minimum voting and minimum market value interests. Deficiencies existing under the previous credit continuity provisions have been corrected and the continuity threshold has been reduced from 75% to 66%.

The tax recovery provision - section 276 will now enable Inland Revenue to seek recovery of tax from both the directors and shareholders of a company. Moreover, these directors and shareholders must have been present at the time the arrangement (which left the company unable to met its tax liabilities) was entered into. To this extent, the provision is better targeted.

The qualifying company regime was first discussed in the Valabh Committee's discussion document on *"Distributions from Companies"* in November 1990. The regime is targeted at closely held companies and essentially treats the company and its shareholders as one entity in a fashion more in line with the tax treatment of partnerships.

Note that section references in italics refer to the Income Tax Amendment Act (No.2) 1992. Other section references are to the Income Tax Act 1976.

Amending legislation for the livestock and depreciation regimes was also passed in the Income Tax Amendment Act (No 2) 1992. These and other miscellaneous items will be covered in detail in a later TIB.

Part I - Dividends

Introduction

The Income Tax Amendment Act (No. 2) 1992 makes many changes to the definition of "dividends" and to dividend related sections of the Income Tax Act 1976.

This Part of the TIB covers the following areas:

Technical amendments to the definition of bonus issue dividend contained in sections 3, 4 and 4A of the Act

Many of these changes have been made in response to the recommendations of the Valabh Consultative Committee which are contained in its two Reports on the Taxation of Distributions from Companies, released in November 1990 and July 1991. Other amendments are required to take account of the removal of the intercorporate dividend exemption from 1 April 1992.

Amendments to section 63 of the Act which provides exemptions for companies from the taxation of dividends

The general intercorporate dividend exemption has been removed with effect from 1 April 1992. However, temporary exemptions have been inserted in section 63 for dividends paid between members of a specified group, and for redemptions of units and interests from certain unit trusts and group investment funds.

Changes to resident withholding tax, fringe benefit tax and imputation consequent upon removal of the intercorporate dividend exemption

From 1 April cash and non-cash dividends are treated alike - that is, they may have imputation credits attached and are taxable to the recipient. The above regimes have been amended to reflect this.

Section 2 - Definitions

Definition of "non-cash dividend"

Section 2(7) replaces the section 2 definition of "non-cash dividend". The substantial definition is now in section 4(3) and a cross reference to that definition appears in section 2.

Section 2(9) inserts into section 2 a cross reference to the definition of "unit trust" in section 211. References to unit trusts appear in amendments to section 63

Section 3 - Bonus Issues

Summary

- Previous section 3 is replaced
- Structural changes are made
- Definition of "ten year bonus issue" is inserted

Section 3 replaces the existing definition of "bonus issue" in section 3. The replacement takes effect from 1 April 1992.

Most of the change is structural. All definitions relating to bonus issues - for example, "taxable bonus issue" and "non-taxable bonus issue" - now appear in section 3(1). They previously were contained in section 4(3). The right of election (as to whether a bonus issue is taxable or non-taxable) now in section 3(3) appeared previously in section 4(5).

Amounts previously excluded from definition of bonus issue

The definition of "bonus issue" has been expanded to clarify that bonus issues made before 20 August 1985 from capital gains and bonus issues from asset revaluation reserves before 16 December 1983, which were excluded from the definition of "bonus issues" at the time, are not bonus issues for the purposes of the Act.

Amounts bonus issued from capital gains between 1985-88

A definition of "ten year bonus issue" has been inserted into section 3(1). The definition refers to bonus issues which were subject to the 10 year rule - i.e. bonus issues made between 31 March 1982 and 1 October 1988. Amounts bonus issued during this time could be distributed tax free after 10 years.

The definition was inserted as a result of the Valabh Committee recommendation that, where bonus issues were made from capital gains between 20 August 1985 and 1 October 1988, the amount bonus issued should be tax free on winding up regardless of whether the 10 year period had expired. This is because capital gains are tax exempt on distribution in a winding up.

The Valabh Committee recommended that this should be effective from the date of assent of the Bill. However, this has been changed to 30 September 1991. The substantive change is effected in section 4A(1)(c), 4A(2) and 4A(2A).

Application Date

The new section 3 comes into effect on 1 April 1992. However, *section 5(15)* retrospectively applies the definition of "ten year bonus issue" where it is used in those provisions of section 4A which apply from the 1988/89 income year (in particular, section 4A(1)(c)). In substance, this is only for the period from 30 September 1991 to 1 April 1992.

Section 4 - Amendment of Dividend Definition

Summary

- Shareholder capacity test is inserted
- Credit to shareholder's account is a *cash* dividend
- Retained earnings test in 4(1)(ba) and (e) is deleted
- Dividend paid to associate of shareholder is derived by associate
- Dividends arising from use of company property are paid up to 6 months after end of income year of payer
- Companies may use market rate of interest in determining dividend arising from intercorporate loans
- Shareholder may retrospectively credit salary, interest and dividends to eliminate debit in shareholder current account
- Low-compliance method of calculating dividends arising in relation to corporate shareholder current account is inserted

Section 4 amends section 4 of the Act, which provides a list of items which are included in the definition of "dividend".

Shareholder capacity test

A shareholder capacity test has been inserted into the opening words of section 4(1). To be a dividend, an amount must be received by a shareholder in that capacity.

New subsection 4(1A) provides that, in determining whether any payment is made by a company having regard to that person's capacity as a shareholder in the company, the fact that the payment is made on terms which differ from those on which the company would make any similar payment to someone who was not a shareholder is indicative of the fact that the payment is made having regard to the person's capacity as shareholder. However, other factors might also indicate that an amount is received in a shareholder capacity.

So, for example, where a corporate shareholder receives from a company a trading credit which is advanced to all those who trade with the company, the benefit does not pass to the shareholder by virtue of its shareholding.

Inland Revenue will issue a more detailed TIB item on the circumstances in which a benefit is received by virtue of shareholder capacity.

Credits to shareholder accounts are cash dividends

Section 4(1)(b) amends section 4(1), clarifying that paragraph (a) applies to monetary amounts including credits to shareholder accounts. This means that such credits are ***cash*** dividends for the purposes of the qualifying company regime and resident withholding tax (refer to the definition of "non-cash dividend"). This does not represent any change but is merely for the purposes of clarification.

Loans to shareholders

Section 4(1)(c) deletes section 4(1)(b) with effect from 1 October 1989. That paragraph provided for the Commissioner to deem the principal of a loan to a shareholder to be a dividend where it was not a bona fide loan. This paragraph is now redundant: any concessional interest element of a loan is a dividend under paragraph (e) and any forgiveness of the loan is a dividend under paragraph (ba).

Deletion of retained earnings test in section 4(1)(ba) and (e)

Section 4(1)(d) and (e) delete the "retained earnings" test from paragraphs (ba) and (e), as recommended by the Valabh Committee. From 1 April 1992, it will no longer be necessary for a company to have profits for a distribution from that company to be a dividend.

Notional distributions from producer boards and co-operative companies

Section 4(1)(f) makes no substantive change to the dividend definition. Notional distributions made under sections 394U and 394ZA are already deemed to be dividends. It is considered helpful to include in section 4(1) all items which are deemed to be dividends under other provisions of the Act.

Group Investment Funds

Section 4(2) amends provisions relating to group investment funds, the taxation of which is covered by section 211A of the Act. They are taxed as companies in relation to category A income. This amendment clarifies that section 4(2)(b) applies only to payments of category A income.

Definitions

Section 4(3) inserts section 4(3) which provides definitions of terms used in the dividend provisions.

The definition of "bonus issue" is a cross reference to the section 3 definition.

"Non-cash dividend" is defined, which is relevant for the purposes of resident and non-resident withholding tax calculations and the qualifying company regime. A credit to a shareholder's account is excluded from the definition of non-cash dividend.

Value of 4(1)(e) benefits and election for bonus issues

Section 4(4) repeals section 4(4)(b), which provided valuation rules in relation to section 4(1)(e) dividends (use of company property). These have been incorporated into the valuation provisions of section 4(10).

Section 4(5) has also been repealed because the right to elect whether bonus issues are taxable is now contained in section 3.

Dividend paid to associate of shareholder derived by associate

Section 4(5) amends section 4(7), enacting the Valabh Committee recommendation that, where an amount is paid to an associate of a shareholder, a dividend arises to the associate and not to the shareholder.

Repayment of loan to shareholder

Section 4(6) amends section 4(8), which provides for amendment of an assessment where a shareholder who has received a loan from a company which has been deemed to constitute a dividend repays the loan. The subsection has been amended as a result of several changes which have occurred - the repeal of paragraph 4(1)(b), the introduction of paragraph 4(1)(ba) and the imposition of fringe benefit tax on non-cash dividends prior to 1 April 1992.

It is now also obligatory on the Commissioner to amend an assessment where he is informed of the repayment of the loan.

The amendment is effective from 1 October 1989 unless the Commissioner has amended an assessment of tax or fringe benefit tax between that date and the date of assent of the Income Tax Amendment Act (No.2) 1992. This operates to ensure that any amendment of an assessment by the Commissioner during that period stands.

Payment and valuation of dividends arising from use of company property

Section 4(7) replaces the previous section 4(10), which provided valuation rules in relation to dividends arising from loans to shareholders.

The new section 4(10) has been expanded to apply to all benefits passing under section 4(1)(e), not just concessional interest loans.

It is now clear, in section 4(10)(a), that such dividends are *paid to,* and derived by, shareholders for the purposes of the resident and non-resident withholding tax and dividend withholding payment regimes. It has been argued in the past that it is not clear that such dividends are “paid” for the purposes of the non-resident withholding tax and foreign dividend withholding payment regimes.

- **Section 4(1)(e) dividends paid up to 6 months after income year of payer**

Section 4(1)(e) dividends are calculated quarterly (to mesh with the valuation rules provided in the fringe benefit tax regime) but are paid and derived on the date the shareholder is notified of the amount of the dividend or, at the latest, 6 months after the end of the income year of the paying company. This is to ease compliance costs for companies.

The concession does not apply for the purposes of the qualifying company regime.

Companies that wish to take advantage of the 1 year exemption for dividends paid between companies in specified groups in section 63(2F) may prefer to derive such dividends at the end of the income year of the paying company.

- **Valuation of dividends arising from use of property**

As section 4(10) now applies to all types of section 4(1)(e) dividend, a general valuation rule has been inserted into paragraph 4(10)(b). This applies to dividends arising from the use of company property, except the granting of a loan to a shareholder.

For example, where the shareholder (who is not an employee) has free use of a house owned by the company, the dividend arising will be calculated under section 336O(6) - the market rent for that property. (Use of a house is not generally covered by fringe benefit tax, but by section 72. However, paragraph (b) applies notwithstanding anything contained in the section 336N(1) definition of fringe benefit.)

Valuation of dividends arising from concessional interest loans

Section 4(10)(c) provides that as a general rule, where there is a concessional interest rate loan, the amount of the dividend is the difference between the rate of interest which applies to the loan under subsection 4(11), calculated on a daily basis, and the amount payable by the shareholder during the quarter.

Subsection 4(11) is new and provides the benchmark for calculating the amount of dividend arising where there is a concessional interest loan.

Section 4(11)(a)**(i)** provides that where the loan is to an individual shareholder, the benchmark against which to calculate the amount of dividend arising is the prescribed rate of interest applying for valuation of concessional interest loans under the fringe benefit tax regime.

This is also the rate applicable where the loan is to a corporate shareholder and the lender elects that the FBT rate will apply. In practice, because a concessional interest loan will generally be advanced by a company to a corporate shareholder where there is a close association between the two, the shareholder will be able to influence this election.

Section 4(11)(a)**(ii)** provides that where the loan is payable in a currency other than NZ currency, the benchmark rate is the rate the Commissioner has prescribed for the currency for the quarter. This is obligatory for an individual shareholder (where the Commissioner has prescribed a rate), but a company advancing a loan to a corporate shareholder may elect to apply this rate. The Commissioner has not to date prescribed any rate under this paragraph.

Section 4(11)(a)**(iii)** effectively provides that the benchmark in relation to a loan to a corporate shareholder is a market rate of interest unless the lender elects to apply the rates referred to above.

Retrospective crediting of shareholder current account to eliminate loan

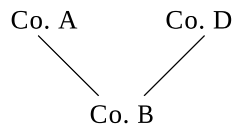
Section 4(11)(b) applies to shareholder current accounts and mirrors section 336O(2A), which applies to shareholder / employees.

Where a shareholder's current account is in debit during a year and the shareholder subsequently has credited to the account dividends (which will be cash dividends) or interest which are not resident withholding income and are assessable income of the shareholder in that year, the amounts are credited from the beginning of the year or, if later, the date the account went into debit.

This provides a mechanism to eliminate any dividend arising under a shareholder current account where there is no loss to the revenue in so doing.

This will be of advantage to corporate shareholders, because intercorporate shareholder current accounts will generally operate only in relation to companies within a group and dividends paid within a group are not resident withholding income (section 327B(2)(b)(via)).

Example



Co. B is 90% owned by Co.. A. Co. A has a shareholder current account with Co. B. No interest is charged on the account and it has had a $1000 debit balance from 1 April 1992.

In August 1992, Co. B pays a cash dividend of $1000 to Co. A by crediting its shareholder current account. That dividend has no imputation credits attached. It is not resident withholding income and is returned by Co. A in same year. The $1000 is deemed to have been applied in repayment of the loan from the beginning of the year. No section 4 (1)(e) dividend arises.

Low-compliance method of calculating balance in corporate shareholder current account

New section 4(11)(c) provides a mechanism for calculating the dividend arising from an inter-corporate current account advance which should reduce compliance costs for companies.

The general rule for calculating the dividend arising from a concessional interest loan is set out in section 4(10)(c). That section requires calculation of the daily balance owing under the loan.

This concessional rule provides that, for companies operating a shareholder current account, the company advancing loans under that account may elect that the daily balance of the loan is the average of the outstanding balance of the loan at the end of each month in the year. Alternatively, it can elect that the daily balance is the average of the balances at the beginning and end of the income year.

This mechanism can only be used, however, where the difference between the dividend which would be calculated under the general rule requiring the calculation of actual daily balances and the dividend calculated under this concession is 30% or less.

Benefit arising from use of company property by corporate associate of shareholder excluded from dividend definition for 1 year

Section 4(7) also inserts a new subsection (12) into section 4. It provides that, from 1 April 1992 until 1 April 1993, the use of a proprietary company's property by a corporate associate of a shareholder of the company will not constitute a dividend under section 4(1)(l). This will chiefly apply to remove from the scope of the dividend definition for one year the concessional interest element of loans provided by a parent to a subsidiary, or between sister companies.

However, new section 4(12) will also cover ***use*** of any other property of the company by the associate.

As a result, resident and non-resident withholding tax and foreign dividend withholding payment are not payable on such benefits passing to associates during that period.

This rule only applies where the property is not made available to the associate in lieu of the company providing a benefit to the shareholder.

Transitional: Dividends paid to an associate of a shareholder between 1 April 1988 and 31 March 1992

Section 4(5) replaces the previous section 4(7), under which dividends paid by a proprietary company to an associate of a shareholder were deemed to be derived by the shareholder. The Valabh Committee recommended that from 1 April 1992 such dividends be derived by the associate.

In addition, they recommended that where dividends were paid to associates between 1 April 1988 and 31 March 1992, taxpayers could in effect elect whether the dividend would be derived by the shareholder or associate.

In order to avoid a formal election, *section 4(11)* provides that, where a dividend was paid to an associate during that period, the associate is deemed to derive the dividend in two circumstances:

a) where the associate includes the dividend in assessable income for the year the dividend was derived;

b) where the dividend would have been exempt from income tax and where there was no requirement to deduct dividend withholding payment from that dividend.

Example

A
|
Co. B
|
Co. C

A is a shareholder (but is not an employee) of Co. B, which in December 1990 advanced a low interest loan to its subsidiary Co. C. Both companies are resident in New Zealand. The concessional interest element of a loan advanced to a shareholder is a dividend under section 4(1)(e). Where it is advanced to an associate of a shareholder, it is a dividend under s4(1)(l).

Section 4(11) provides that, in this situation, that dividend is derived by Co. C. Until 31 March 1993, such dividends derived by Co. C are exempt from tax. Accordingly by virtue of section 4(11), Co. C (and not A) would be deemed to derive the dividend income. No election would need to be made by Co. C.

Section 5 - Exclusions from the Definition of Dividend

Section 5 makes amendments to section 4A, which excludes items from the definition of dividend.

Summary

- Previous paragraphs 4A(1)(c) to (g) (tax free returns on redemption of shares) are amalgamated into new 4A(1)(c)
- Amounts bonus issued from capital gains between 20 August 1985 and 1 October 1988 are tax free on winding up from 30 September 1991
- Capital gain amounts retain character when distributed to resident corporate shareholders on winding up

Section 5(1) repeals section 4A(1)(b) with effect from the 1988/89 income year. That paragraph only applied to distributions made between 1 April 1988 and 1 October 1988. In relation to distributions made between the 1 April 1988 and 1 October 1988, the exemption provided by this paragraph is encompassed in new section 4A(1)(c).

Amounts which are tax free on redemption of shares

Section 5(2) amalgamates previous paragraphs (c) to (g) of section 4A(1), all of which relate to the tax free element of a dividend on full or partial winding up. The new section 4A(1)(c) is backdated to the 1988/89 income year unless a taxpayer elects otherwise. This is because it remedies certain defects in the previous provisions. It is considered that taxpayers would prefer the retrospective change. However, for those who may be penalised by this, a right of election to apply the previous provisions is available.

Paragraph 4A(1)(c) lists those amounts which may be returned tax free on the redemption or cancellation of a share, subject to the Commissioner being satisfied redemption is not in lieu of the payment of a dividend. The tax free amounts are the:

- "returned capital amount"
- "returned share premium amount" and
- "excess return amount" where the company is winding up.

These terms are defined in section 4A(2A).

The definition of these terms refers to the definition of "shares of the same class" in section 4A(2) and it is helpful to consider first when shares are of the same class.

Shares of the same class

Two shares are of the same class when they carry :

- the same right to exercise voting power in relation to the company's constitution, distributions, variation in capital and election of directors; and
- the right to the same amount per share of distributions of profits, assets, paid up capital and qualifying share premium.

Example 1: If one share has $1 paid up capital, another has $2 paid up, and the company is required to repay those differing amounts to the respective holders of the shares, the shares are in different classes.

Example 2: Two shares have capital of $1 paid up. The premium paid on one is $0-50 and the other $1-00, but the holders are each entitled to receive the return of $0-75 of share premium. The shares are in the same class.

Under paragraph (c), two shares are also of the same class where they have the same rights set out above but where the amount per share paid on issue is the same and that amount differs from the amount paid on issue of other shares in the company. This requires a company to be able to identify and distinguish those shares from other shares in the company and to elect that those shares are in the same class.

Example: A company has the following shares:

1 share $1-00 capital fully paid, $1-00 premium paid to $0-50

1 share $1-00 capital fully paid, $1-00 premium fully paid.

In terms of the constitution, both shares carry the right to distributions of the same premium. However, the company can identify and distinguish the two shares, and the holders of them, and elects that they will be in separate classes. The two shares are then treated as shares of different classes.

Returned capital amount

The returned capital amount (defined in section 4A(2A)) is in effect:

- all amounts of capital ever paid up on shares of the same class as those being redeemed, pro-rated across

- the total number of shares of that class ever issued prior to the redemption.

This does not include "non-qualifying capital" (defined in section 4A(2)), which is essentially 10 year bonus issues which are still serving time and non taxable bonus issues. These amounts are not returned tax free on redemption of shares during the life of the company. However, on winding up of the company, amounts bonus issued from capital gains and qualifying share premiums may be returned tax free. This applies to 10 year bonus issues, only after 30 September 1991.

Returned share premium amount

This is also defined in section 4A(2A). It is in effect:

- the total amount of qualifying share premium paid prior to the redemption in relation to shares of that class which have ever been issued (i.e. the class referred to above in the definition of returned capital amount), pro-rated across
- the number of shares in that class.

The formula refers to "the lesser of the amount debited to the company's share premium account in respect of the redemption" and the amount calculated as described above. This is a mechanism for ensuring that a distribution must be made from the company's share premium account in order for the distribution to be tax free.

"Qualifying share premium" is defined in section 4A(2) and is in the same terms as the previous section 4A(1)(e). It applies to any premium paid that was credited to a share premium account and did not arise from the issue of shares in one company as consideration for the acquisition of shares in another company.

Example

Class A shares - 10 shares $1-00 capital fully paid $0-50 premium fully paid.

Class B shares - 10 shares $1-00 capital fully paid $1-00 premium fully paid.

(The shares carry the right to different amounts of premium on redemption and therefore are in two classes).

Distribution to each shareholder in respect of

- class A shares is $1-50 per share
- class B shares is $2-00 per share

Amount which may be returned tax free per share:

Returned capital amount -

class A - $10 / 10 = $1

class B - $10 / 10 = $1

Returned share premium amount -

class A - $5 / 10 = $0-50

class B - $10 / 10 = $1-00

Excess return amount

This amount is tax free only on winding up of the company.

The excess return amount is:

> The amount per share received by a shareholder on winding up, less returned capital and share premium amounts, multiplied by the formula set out in the definition.

The formula is in effect capital gain amounts distributed to shareholders on winding up, together with unallocated share premium, divided by the total amount received by shareholders on winding up, less returned paid up capital and returned share premium amounts.

It is essentially the shareholder's share of capital gains and capital assets distributed on winding up.

Unallocated share premium is included in the amount which is tax free under this head. Very little share premium should fall into this category - possibly only in the very rare event that a class has been redeemed but share premium belonging to that class has not been returned.

Example

Company A has two shareholders, B and C.

B has 10 $1 shares paid up with $0-50 premium fully paid

C has 10 $1 shares paid up with $1-00 premium fully paid

(Cont'd on Page 10)

(From Page 9)

The shares do not carry the same rights to return of premium and therefore are in different classes.

Reserves of company A at the time of winding up are:

$	
20	paid up capital
15	share premium
500	capital gains
670	retained earnings
1,205	

It has $330 in its imputation credit account.

This example sets out the amount which is an assessable dividend in the hands of B.

On winding up B receives per share

1.00	p.u.c.
0.50	premium
25.00	capital gains
33.50	retained earnings
60.00	

$16-50 imputation credits are attached to the dividend.

Amounts which are not an assessable dividend per share:

1. returned capital amount -

$$\frac{\$10}{10} = \$1$$

2. returned share premium amount -

$$\frac{\$5}{10} = \$0.50$$

3. excess return amount -

$$\$60 - \$1.50 \times \frac{\$500}{\$1205 - \$15 - \$20} = \$25$$

B therefore receives dividend income of $50.00 ($33.50 plus $16.50 imputation credits). No tax is payable by a shareholder on a .33 rate.

Benefits paid to shareholder/employees not a dividend

Section 5(3) amends section 4A(1)(i), which takes out of the dividend definition benefits paid to shareholder/employees. This removes any exposure to double taxation which may occur because a benefit is taxable both as a dividend and under the fringe benefit tax regime.

The scope of the paragraph has been extended to cover all benefits which could be dividends. So, for example, where a benefit is provided to an associate of a shareholder/employee, and is subject to FBT, it is not a dividend. This amendment is retrospective to the 1988/89 income year.

Use of property not a dividend if included in income under section 72

Section 5(4) inserts into section 4A(1) a new paragraph, (ia), which prevents double taxation where a benefit, being use of a house, is taxed to a shareholder under section 72. This may occur where the shareholder is also an employee of the company providing the house. This amendment is also retrospective to the 1988/89 income year.

Capital gain amount retains character when distributed to corporate shareholder on winding up

Section 5(6) ensures that, where amounts which are capital gains in the hands of a company which is winding up are distributed to a corporate shareholder, they retain their character. This change does not apply where the recipient is non-resident - see the section 309(2) definition of “dividend”.

Definition of “specified company”

Section 5(8) provides that the definition of “specified company” is in substance the same as the previous definition. It is used in the definition of dividend in section 309(2).

No double taxation of non-qualifying amounts on distribution

Section 5(9), apart from inserting the definitions of terms used in section 4A(1)(c), replaces the previous section 4A(3) with one which takes account of the new form of section 4A(1)(c). There is no change in substance.

Payment for shares in foreign currency

Section 5(9) also inserts a new subsection, (3A), into section 4A. It clarifies that where paid up capital or premium was paid in a foreign currency on the issue of shares, the amount paid is deemed to be equal to the amount that would have been paid in New Zealand dollars to make the payment of premium or paid up capital in foreign currency if payment was made on the date of redemption.

Example

A NZ shareholder paid $NZ300 in March 1989 to pay up capital of $A200 in relation to shares in an Australian company. The shares are redeemed in January 1993, by which stage $A200 = $NZ350. In calculating the amount which is not a dividend on redemption, the amount paid to the company to pay up the shares is deemed to be $NZ350.

Changes consequential upon amalgamation of previous section 4A(1)(c) - (g)

Section 5(10) makes changes in section 4A(6) and (7) to refer to the new section 4A(1)(c).

Capital losses reduce capital gains available for tax-free distribution on winding up

Section 5(11) amends section 4A(11), which previously provided that, in determining the amount of capital gain which is not a dividend on winding up, capital gains are reduced by capital losses arising in the same year, or a year subsequent to that, in which the capital gain arose.

Section 4A(11) now also provides that capital losses which arise in or after the 1992-93 year, in a year prior to that in which the capital gain arose, will also reduce the capital gain amount.

Section 6 - Use of the term Dividends

This section inserts into the Act a section 4B which sets out the meaning of the term "dividend" as it is used in different sections of the Act, or which provides a cross reference to the section in which the section 4 definition is modified.

Those provisions in the now repealed section 394ZC have been moved to subsections 4B(1) and (2).

Section 9 - Intercorporate Dividend Exemption

Summary

- A 2 year exemption is provided for dividends paid on pre-Budget redeemable preference shares
- There is a 1 year exemption for dividends paid between members of a specified group
- A 1 year exemption is provided for dividends arising on redemption of units in certain unit trusts

Section 9 makes several amendments to section 63 of the Act.

Redeemable preference shares

Two amendments have been made to provisions inserted into section 63 shortly after the 1991 Budget. Under those provisions - section 63(2C) and (2D) - dividends paid on redeemable preference shares issued after the 1991 Budget are taxable.

Section 9(1) substitutes the words "the person deriving the dividend" for "any person" in section 63(2C)(b)(i). This is to clarify that where a dividend is paid after the 1991 Budget to a shareholder of a share issued pre-Budget and the share is subsequently sold, the dividend is not taxable.

Section 9(2) amends subsection 63(2D) which defines fixed rate share. Paragraph (a) has been replaced with a provision which clarifies that a share is *still* a fixed rate share even though there is provision for the amount of dividend payable on the share to vary:

- by a fixed relationship to a rate of income tax *and/or*
- to compensate the shareholder for any default by the company paying the dividend or loss suffered by the shareholder.

Grandfathering of redeemable preference shares

Section 9(3) inserts section 63(2E) which retains the intercorporate dividend exemption until 1 April 1994 for dividends paid on pre-Budget fixed rate redeemable shares. "Fixed rate" is in effect defined in paragraph (h). A share is considered fixed rate even if there is provision for the dividend payable on a share to vary according to the income tax payable on the dividend. A "share" includes a:

- section 192 or 195 debenture,
- fixed rate unit in a unit trust.

Included as exempt are dividends paid on shares acquired after the Budget pursuant to a pre-Budget binding contract. However, where shares were acquired after the Budget because of the exercise of a pre-Budget option to put or sell the shares, the dividends paid on the shares are not exempt.

The exemption is subject to the condition in (2E)(e) that no term of the share is altered after Budget (except where the alteration is pursuant to a pre-Budget binding contract).

It is not uncommon for a contract for the issue of shares to require collateral security to be provided by the issuing company or an associate. Concern has been expressed that where such a security is substituted, this may constitute an alteration of the term of the share, for the purposes of this provision and section 63(2C)(b)(ii). Such substitution is not considered to constitute an alteration of the term of the share.

The share is also not grandfathered where a post-Budget financial arrangement has been issued to defeat the intended application of the section, which is to exempt until 1 April 1994 dividends paid in respect of pre-Budget, unaltered redeemable preference shares.

There are some exceptions to the grandfathering which are contained in paragraphs (b) and (c). In relation to (b), dividends derived from foreign companies are exempt from tax anyway under subsection 63(2A). Dividends derived from exempt companies, and dividends set out in subsection (2J), were taxable prior to the general removal of the intercorporate dividend exemption.

Exemption for dividends paid within specified groups

Section 63(2F) retains the intercorporate dividend exemption until 1 April 1993 for dividends paid between members of a specified group. At that stage, companies will have the option to consolidate for income tax purposes. Dividends paid between members of a consolidated group will remain exempt.

Definition of Specified Group

A Paid up capital

"Specified group" status is determined by reference to the repealed section 191(4) and (6)(b) - i.e. the pre-1992/93 specified grouping requirements are retained for the purpose of the 1 year exemption. Group status is determined at the time a dividend is paid.

A dividend is exempt where at the time of payment the same persons hold the whole of the paid up capital in the same proportions in the payer and recipient companies.

Fixed rate dividend shares are not taken into account.

The other general provisions of section 191 apply, of course, in determining group status so that, for example, the Commissioner has power under section 191(6A) to disregard a small amount of paid-up capital.

B Voting Interests

Although paid up capital is the primary test to determine specified group status, companies can elect to apply a test based on the voting interests of shareholders. This forms the basis of the new grouping rules. The "common voting interest" test (section 191(2)(a)) in this context requires that at the time of payment of the dividend, there is a group of persons who hold 100% of the voting interests in the same proportion in the payer and recipient companies.

Any election to group on the basis of voting interests must be made by notifying the Commissioner at the time the first dividend is paid after 1 April 1992. That election is irrevocable - that is, where it is made, dividends paid until 1 April 1993 are exempt only where shareholders have 100% of the common voting interests in the recipient and payer companies at the time the dividend is paid.

Voting interests are defined in section 8C. For an explanation of the operation of that provision see Part II. Fixed rate shares are excluded if they carry insignificant voting rights.

Both methods of determining specified group status are subject to an anti-avoidance provision in subsection (2G). Where the Commissioner considers that any shares in either the recipient or payer company have been subject to any arrangement for the purpose of enabling those companies to be a specified group, the dividend will not be exempt under subsection (2F).

Redemption of units in unit trusts

Section 63(2H) provides for dividends arising from the redemption of units in certain unit trusts, and redemption of interests in certain group investment funds, to be exempt until 1 April 1993.

Background

Corporate managers of unit trusts act as intermediaries in the sale and purchase of units. Where no purchaser for a unit is available, the unit trust redeems the unit from the manager. Part of the redemption proceeds may be a dividend to the manager.

Until 1 April 1992 that dividend was exempt. The Government requires adequate time to consider how to address the impact of removing the inter-corporate dividend exemption on unit trusts, and to consult with unit trust operators in that process, particularly in view of the Valabh Committee's proposals to modify the treatment of unit trusts for tax purposes. It proposes to do this following passage of the Income Tax Amendment Act (No. 2) 1992. In the meantime, it is concerned that public unit trusts are not placed at a disadvantage vis a vis companies and overseas unit trusts.

The Government is also concerned to ensure that no opportunity exists for a general exemption for redemption of units to be used to enable companies to avoid the taxation of intercorporate dividends.

The exemption on redemption from a manager is therefore granted until 1 April 1993 for three categories of unit trusts:

- unit trusts with 100 or more unassociated unit holders
- unit trusts with fewer than 100 unassociated unit holders, where the Commissioner is satisfied that the unit trust
  - is a widely-held investment vehicle for direct investment by members of the public; or
  - has fewer than 100 unit holders because of temporary or unusual circumstances
- units trusts which have made an election to forego the temporary intercorporate dividend exemptions in relation to pre-Budget redeemable preference shares and dividends paid within specified groups.

Group investment funds operate in a similar way to unit trusts in relation to category A income, and the rules applying to unit trusts also apply to such funds in respect of that income.

Exemptions do not apply to dividends taxable prior to 1991 Budget

Section 63(2J) provides that the exemptions granted in relation to members of specified groups, pre-Budget redeemable preference shares and unit trusts do not apply to dividends which were taxable prior to the 1991 Budget.

Miscellaneous Dividend Amendments

Section 10 - Accruals Regime

Section 10 makes two minor amendments to the accruals regime.

The Bankruptcy Act has been repealed and the reference to that in section 64F(1)(c) is therefore redundant.

Forgiveness of debt - section 4(1)(ba) and 4(1)(l) dividends

Where a company forgives a debt owed to it by a shareholder, the forgiven debt is a dividend under section 4(1)(ba). Forgiveness of debt is also taxable under the accruals regime. To avoid double taxation, any section 4(1)(ba) dividend is excluded from the base price adjustment in section 64F(2) of the accruals provisions. It is therefore taxable under the dividend provisions rather than the accrual rules.

Section 64F(2) has been amended so that where an associate of a shareholder is forgiven a debt owed to a company, and that amount is an assessable dividend under section 4(1)(l), it is excluded in calculating the base price adjustment in relation to the associate.

The amendment applies from 26 July 1989 - the date that section 4(1)(ba) dividends were excluded from the base price adjustment.

Section 4(1)(l) dividends which arise on forgiveness of a debt are, like section 4(1)((ba) dividends, taxable to corporates and do not qualify for any of the temporary exemptions from tax granted to companies under section 63.

Section 15 - Deduction for Expenditure in providing Fringe Benefits to Employees

Section 105A has been redrafted so that it is more comprehensible. It now applies to all, not just private, companies.

Section 27 - Distribution of Trading Stock to Shareholders

Unnecessary words have been deleted in section 197(3).

Sections 35 - 38: Non-Resident Withholding Tax on Dividends

Summary

- Capital gains distributed to a corporate shareholder on winding up do not retain their character
- Formulae are inserted for calculating NRWT on non cash dividends

Sections 35 to 38 amend the non-resident withholding tax regime.

Capital gains distributed to corporate shareholder on winding up do not retain character

Section 35 amends the section 309(2) definition of "dividends" by adding paragraph (a)(ii). It provides that capital gains made by a New Zealand corporate which are paid on winding up of the company to a related foreign corporate shareholder are subject to non-resident withholding tax. Whether companies are related is determined under section 4A(12) - essentially, companies are related if one owns 20% of another.

Formulae for calculating NRWT on non-cash dividends

Sections 36 and 37 align the format of the provisions requiring deduction of non-resident withholding tax with that of resident withholding tax.

Section 36 repeals section 312(4). This change, together with the amendments in *Section 37*, means that a deduction of NRWT is not made in relation to taxable bonus issues and non-cash dividends, but in its stead the payer of the dividend makes a payment to IRD of an amount equivalent to such a deduction.

Section 37 replaces the previous section 313. There are now formulae for calculating the amount of NRWT to be paid in relation to non-cash dividends.

The formula for non-cash dividends which are not taxable bonus issues is

$$\frac{a}{1 - a} \times b$$

where "a" is the rate of non-resident withholding tax and

"b" is the amount of dividend paid.

In relation to “a” where a lesser rate is payable under a treaty, then “a” is that rate.

Example

Co. A pays to a non-resident $100 non-cash dividend. It has no imputation credits attached. NRWT is applicable at the full rate of 30%. Under section 313(1)(a) the following amount of NRWT is payable:

$$\frac{0.3}{1-0.3} \times \$100 = \$42.85$$

Imputation and dividend withholding payment credits

The provisions relating to imputation and dividend withholding payment credits attached to the dividend continue to apply.

Imputation credits attached to the dividend have no effect. They are not included in the amount of the dividend (section 309(2)) and no credit against NRWT is available for them.

To the extent that dividend withholding payment credits are attached to the dividend, they are included in the amount of the dividend, so NRWT is payable on both the dividend and credits. The payer of the dividend does not pay NRWT to the extent NRWT is covered by a DWP credit (section 311(2)). Any excess DWP credits are refundable to the recipient (section 394ZQ(2)).

Payment of NRWT

Payments of NRWT are made on the 14th (from 1 July 1992, the 20th) of the month following deductions (section 315).

Section 38 makes a minor technical amendment to section 320(2), which relates to the power of the Commissioner to recover NRWT where there has been default in deduction. It aligns the date on which the NRWT is due to that in section 315.

Sections 39 - 44 - Resident Withholding Tax on Dividends

Summary

- Non-cash dividends are subject to RWT
- No RWT is payable on dividends paid between members of a group of companies

Section 39 makes a minor amendment to the resident withholding tax (RWT) regime. The definition of “taxable bonus issue” in section 327A(1) has been repealed; that term is defined in section 3 for the purposes of the Act.

Section 40 makes three amendments to section 327B, which sets out exemptions from the requirement to deduct RWT.

• Consequential change - grouping

First, section 327B(2)(a)(v) (which provided an exemption from RWT on interest where companies were in the same group) has been amended to fit with the new grouping rules, which enable group status to be determined, where appropriate, on a day by day basis.

• Non-cash dividends subject to RWT

Paragraph 327B(2)(b)(i) has been deleted. Prior to 1 April 1992 non-cash dividends provided to a shareholder were subject to fringe benefit tax. Paragraph (b)(i) therefore exempted such dividends from deduction of RWT.

From 1 April 1992, non-cash and cash dividends will be treated in the same way - i.e. assessable to the recipient. There is therefore a general obligation for a company providing a non-cash dividend to a shareholder (who is not also an employee) to pay RWT on that dividend.

• No RWT on dividends paid between members of a group

New paragraph (via) is inserted into section 327B(2)(b). This provides that dividends (both cash and non-cash) are exempt from RWT where the payer and recipient companies are members of the same group at the time of payment of the dividend.

Deduction of RWT from non-cash dividends

Section 41 makes amendments to section 327C, which provides for the deduction of resident withholding tax. From 1 April 1992 cash and non-cash dividends are treated alike. In general, both will be subject to resident withholding tax.

Section 327C(1)(b) provides the mechanism for calculating the amount of resident withholding tax payable on cash dividends. That paragraph has been amended to ensure that it does not apply to non-cash dividends.

New paragraph (1)(c) applies to non-cash dividends. It provides that RWT payable on a non-cash dividend is calculated in accordance with the following formula:

$$\left(\frac{a}{1 - a} \times b\right) - c$$

where a is the rate of RWT

b is the amount of dividend paid

c is foreign non-resident withholding tax where the dividend is not paid in New Zealand, or

where the dividend is sourced in New Zealand, the amount of imputation and dividend withholding payment credit attached to the dividend

Examples

All companies are resident in New Zealand.

1. Company A owns 70% of Company B. Company B advances an interest-free $1,000 loan for one year (from 1 April 1992 to 31 March 1993) to company A. The market rate of the loan would be 10% p.a., and the dividend arising therefore is $100. The dividend is not credited.

   No RWT is payable as at the time of payment of the dividend Companies A and B are in the same group.

2. Where Company A owns 40% of Company B in the above circumstances, $49.25 RWT is payable, calculated as follows:

   $$\frac{.33}{.67} \times \$100 = \$49.25$$

   Section 4(10)(a) provides that the dividend is deemed to be paid by Company B within 6 months of the end of its income year (assuming the shareholder is not notified of the amount of dividend earlier). Co. B is deemed to pay the dividend on 30 September 1993.

   Section 327C(1) states that a deduction of RWT is to be made *at the time of making the payment of the dividend.* Where a company pays a non-cash dividend from which it is required to deduct RWT the company is to pay to IRD an amount equal to the amount of a deduction. In the above example, therefore, Company B must pay to IRD $49.25.

   Under section 327E(4), that amount is to be paid by the 14th (after 1 July 1992, the 20th) of the month following payment. In this example payment is due on 20 October 1993.

   Co. A will derive income of $149.25 (section 327K(1)) and will receive notification that a dividend of $100 has been paid, in respect of which $49.25 resident withholding tax has been paid (section 394I).

   All the standard provisions of the RWT regime apply. For example, if the recipient has a Certificate of Exemption, no deduction is made.

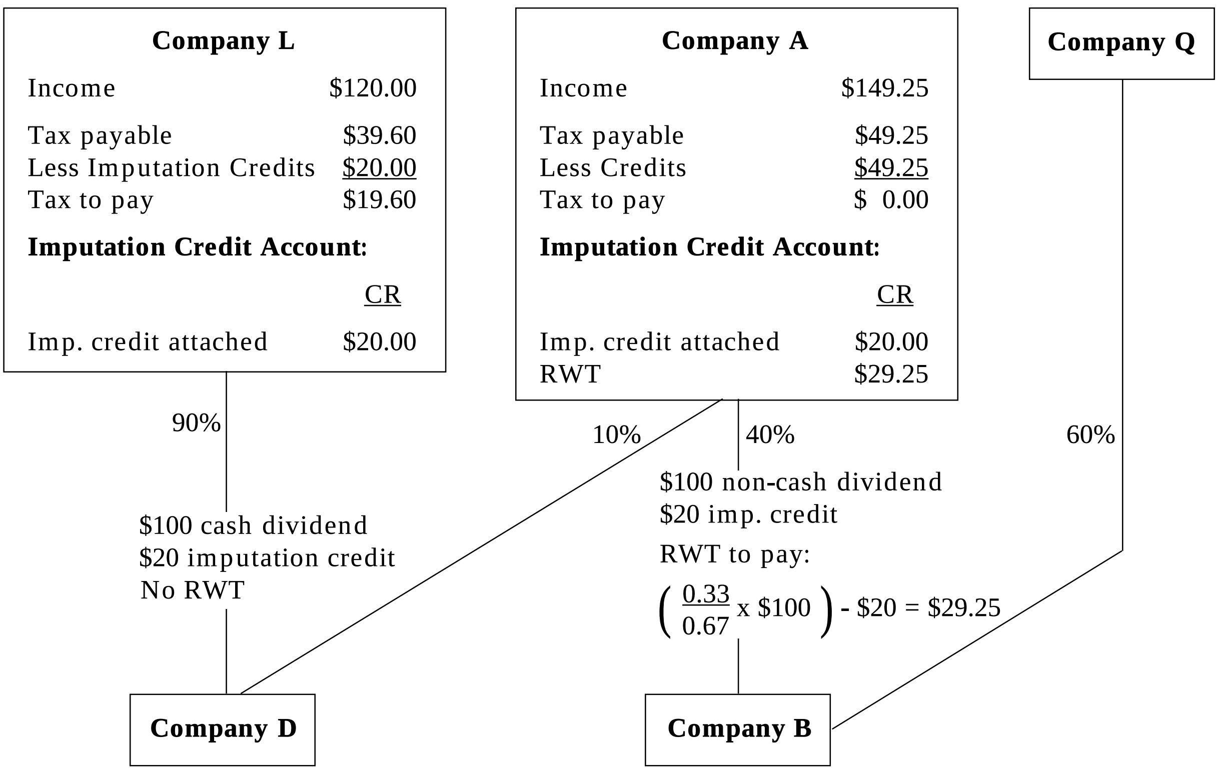
   The recipient company also enters a credit for the resident withholding tax credit in its imputation credit account (section 394D(1)(va)).

   This process is illustrated in the diagram appearing below.

3. If Co. B attaches to the dividend $10.00 imputation credits, the amount of RWT to be deducted is computed as follows:

   $$\left(\frac{.33}{.67} \times \$100\right) - 10.00 = \$39.25 \text{ RWT}$$

Resident Withholding Tax on Intercorporate Dividends



Section 327C(1)(d) retains the current provisions in relation to taxable bonus issues.

Section 41(4) makes an amendment to section 327C(7) of the Act (which sets out circumstances in which no deduction of RWT is to be made) consequent upon the removal of the intercorporate dividend exemption. Paragraph (d) has been deleted. That paragraph provided that liability to withhold RWT is relieved where the payer of dividends has taken reasonable steps to confirm that the recipient of the dividends is a company.

However, dividends which are still exempt from income tax under section 63 (for example, dividends paid under pre-Budget redeemable preference shares until 1 April 1994) are not resident withholding income (section 327B(2)(b)(ii)).

Section 42 amends the section requiring agents and trustees who receive resident withholding income to deduct RWT on receipt. The requirement for such a deduction in relation to taxable bonus issues has been extended to apply to non-cash dividends.

Section 43 amends section 327K, which provides for RWT deductions to be credited against income tax. These amendments are made as RWT deducted from dividends is no longer linked, for purposes of notification and crediting of tax, to the dividend withholding payment regime.

In the case of *all* dividends (and not just specified dividends as previously provided) the amount of resident withholding income includes the amount of RWT deducted (as noted earlier, in the case of non-cash dividends, this includes RWT paid).

Subsection 327K(2) now provides for a credit of tax under that provision for RWT deductions on all dividends.

Section 44 removes the link created in section 327L between RWT deductions and dividend withholding payment credits for notification and crediting purposes.

Sections 45 and 46 - Fringe Benefit Tax

Section 45 makes several amendments to the fringe benefit tax regime.

Summary

- Benefits paid to corporate associates of shareholder- employees in general are not subject to FBT until 1 April 1993
- Benefits paid to non-executive directors and secretaries who are shareholders are derived in shareholding capacity

Benefits Paid to Corporate Associates of Shareholder-employees

First, under a combination of previous subsections 336N(3) and 336N(3A) benefits paid to corporate associates of shareholder/employees were subject to fringe benefit tax (FBT). This results in an unsatisfactory position for the 1992-93 income year, because the tax treatment of certain benefits provided by companies to corporate associates of shareholders differs depending on whether a shareholder owning the company providing the benefit is also an employee of that company.

This situation arises because, under section 4(12), section 4(1)(e) dividends (e.g. concessional interest on loans, use of property) paid by a proprietary company to corporate associates of shareholders are exempt from tax, NRWT and FDWP until 1 April 1993.

The amendment contained in subsection 336N(3A) will take benefits provided to corporate associates of shareholder/employees out of the fringe benefit tax regime and, where the employer is a proprietary company, into the dividend regime (section 4A(1)(i) will not apply to such benefits). A parallel treatment will therefore apply for, amongst other things, low interest loans advanced by Company B to Company C in the following circumstances:

A = shareholder or shareholder/employee
|
Co. B
|
Co. C

The exemption from fringe benefit tax is subject to an anti-avoidance rule. It does not apply where the benefit is provided under an arrangement which has the purpose of providing a benefit to the shareholder/employee.

The amendment to section 336N outlined above will apply with respect to benefits provided on or after 1 April 1992.

Benefits provided to shareholder/ employees

Subsection (3B) restates the existing provision that where a shareholder/employee receives a benefit, it is deemed to be received in the capacity of employee.

Benefits provided to executive officers

Subsection (3C) implements the Valabh Committee recommendation that where a benefit is provided to a non-executive director or secretary of a company and that person is also a shareholder, the benefit is derived in that person's capacity as shareholder.

No fringe benefit tax on non-cash dividends

As fringe benefit tax will not be payable on non-cash dividends after 1 April 1992, section 336N(8) has been repealed with effect from that date.

Section 46 makes an amendment to section 336O(2A) which was recommended by the Valabh Committee. The amendment ensures that where income is retrospectively credited to a shareholder / employee's current account so that a loan does not give rise to an FBT liability, there is also no dividend liability in relation to that current account. The amendment is retrospective, applying to FBT on loans owing after 1 April 1989.

Sections 49 to 61 - Imputation and Dividend Withholding Payment Regimes

Summary

- Imputation credits are attachable to non-cash dividends
- A credit arises for overpaid provisional tax where there is a joint assessment
- There is a requirement for an RWT deduction to be specifically identified in notification to a shareholder
- A company can receive a refund owing following breach of credit continuity

Attachment of imputation credits to non-cash dividends

Section 49 amends the definition of "dividends" for the purposes of the imputation regime. Companies will, after 1 April 1992, be able to attach imputation credits to non-cash dividends.

Imputation Credits and Joint Assessments

Section 50 also amends the imputation regime. A 1990 amendment prevented companies which were jointly assessed crediting all of the tax to the imputation credit account of the company paying the tax. This was achieved by inserting the words "on income derived by the company" in section 394D(1)(a).

As it was expected that consolidation would be in place by 1 April 1992 and therefore the joint assessment process would no longer be operative, *section 50* of the Act as it was introduced merely deleted these words. It is now necessary to retain them until consolidation is available.

However, paragraph (a) has been altered so that it is now clear that it does not prevent companies from obtaining a credit for overpaid provisional tax.

The amendment is retrospective to the 1990-91 income year.

Shareholder Dividend Statements

Section 52 makes several amendments to section 394I, which provides for a company paying a dividend to give information to a shareholder about the dividend.

The first amendment provides for shareholders to be notified wherever resident withholding tax is deducted from a dividend (except in relation to a specified dividend which is essentially a dividend which cannot carry an imputation credit).

A new paragraph 394I(1)(ca) is inserted requiring companies to separately identify in shareholder dividend statements any RWT deducted from the dividend.

Section 52(4) of the Act provides a period of grace in relation to the requirement to separately identify an RWT deduction in the shareholder dividend statement. Strictly, companies at present are not required to separate RWT from DWP credits. However, it appears that most do. In the event that companies are not able to alter their systems from 1 April 1992 and record RWT credits separately, the recipient may treat the RWT credit as a DWP credit.

Refund owing where breach of credit continuity has occurred

Section 53 provides that where a company has failed to maintain continuity in relation to imputation credits and a debit has arisen to its imputation credit account, it may receive a refund of tax which it has owing, despite a nil balance in its ICA, up to the amount of debit arising on loss of continuity.

Grouping of loss arising from conversion of excess imputation credits

Section 54 provides that companies which have excess imputation credits and which convert these to a loss may offset that loss against income derived by another company in the group. At present, companies are only able to do this in relation to imputation credits converted to a loss in a year prior to offset.

Dividend Withholding Payment regime

Section 55 amends section 394ZK(2) as a consequence of the alteration of the "dividends" definition for imputation purposes. Previously, for dividend withholding payment purposes it was necessary to bring back in non-cash dividends which had been excluded under the imputation regime.

Order in which credits of tax are refundable

Section 56 provides an ordering rule between DWP and RWT credits now that an RWT credit is not a DWP credit for the purposes of allowance of a credit of tax. A DWP credit is credited after an RWT credit (which is credited after an imputation credit). This is required so that companies know, where there is a refund of tax, whether to debit the ICA (in the case of a refund of RWT) or DWPA (see section 394ZW(1)(ca)).

Notification where DWP credits attached to dividend

Section 58 makes amendments to section 394ZZB, which provides for notification of shareholders where dividend withholding payment credits are attached to dividends. These amendments are required as a consequence of the decision not to treat RWT credits as DWP credits.

Branch Equivalent Tax Accounts

Sections 59 and 61 implement the Valabh Committee recommendation that taxpayers be able to elect to operate a branch equivalent tax account retrospectively.

Part 2 - Measurement of Voting and Market Value Interests

Introduction

Section 7 inserts into the Income Tax Act new sections 8A to 8F which relate to the measurement of voting and market value interests held in companies by shareholders.

The measurement of such interests is relevant to the following provisions of the Act:

- continuity provisions - sections 188, 191A(1)(b) and (2)(e) 394E(1)(g), 394ZW(1)(f) and 394ZZP(3)(d)
- company grouping and loss offset provisions - sections 190A, 191, and 191A
- recovery of tax from directors and shareholders - section 276
- qualifying company regime - Part XIIAA

The new provisions apply from the 1992-93 income year.

Under the new provisions, shareholders' economic interests in a company will generally be measured by reference to their voting interests held in that company, both directly and indirectly through interposed companies.

In certain circumstances, the shareholders' economic interests in a company will ***also*** be determined by the market value of interests in the company. The circumstances where the market value is also measured are limited to instances where the voting interests do not reflect the true economic interests held in a company.

Special tracing rules have been incorporated to lower the compliance and administration costs of applying the new measurement provisions (for example, by limiting the circumstances where indirect voting and market value interests have to be traced through multiple tiers of companies).

Voting Interests - Section 8C

Summary

- Shareholders' interests in companies are generally measured by reference to voting interests held in companies.
- Voting interests include both direct and indirect voting interests carried by shares or options in that company.
- Voting interest in a company equals the sum of shareholder decision-making rights.
- Requirement to look through all interposed corporate shareholders in a company to determine the ultimate owners of that company.
- Indirect voting interests held through interposed companies are determined by multiplying down each level of direct voting interest in the chain.
- A special corporate entity can't have a breach in continuity as its shares are deemed to be held by the same person.
- Interests held by bare trustees and nominees are required to be traced through to the beneficial owners.

Calculation of voting interests - Sections 8C(1) and (2)

A person's voting interest in a company equals that person's percentage share of the total shareholder decision-making rights carried by shares or options in that company.

Shareholder decision-making rights are defined in section 8B as rights attaching to shares or options to vote or participate in decision-making concerning:

- dividends or other distributions; or
- the constitution of the company; or
- any variation in the capital of the company; or
- the appointment or election of directors.

If the percentage of rights held by a person to vote on these different types of decision-making varies, the average of these percentage voting rights is used to calculate the person's voting interest in a company.

Example 1: Averaging of differing voting rights

A company has two shareholders, Vivian and Chris. The company has two classes of shares. Class A shares carry a right to vote on matters other than the payment of dividends and appointment of directors. Class B shares carry unrestricted voting rights. Vivian holds all 1000 of the A shares in the company while Chris holds all 1000 of the B shares. Vivian's percentage voting interest in the company is calculated as follows:

$$\frac{50}{100} + \frac{50}{100} + \frac{0}{100} + \frac{0}{100} = 25\%$$

Chris's percentage voting interest is therefore 75%

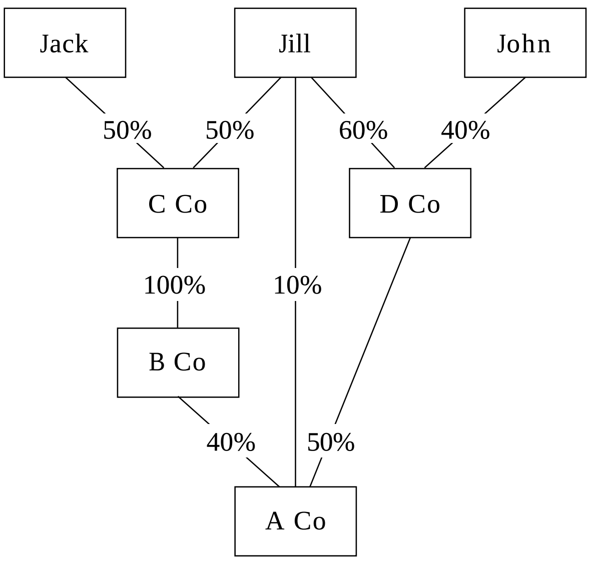
Indirect voting interests - Section 8C(3)(d)

There is a requirement (substantially modified for purposes of the continuity provisions by section 8E), when calculating voting interests held in a company, to look through all interposed corporate shareholders to ascertain the ultimate owners of the company.

The shareholder's indirect voting interest is determined by multiplying the shareholder's voting interest in the interposed company in which he or she owns a direct voting interest by the direct voting interest that each interposed company owns in another company in the chain.

Example 2

Calculation of voting interests (direct and indirect) held in company by natural persons



Voting interests in A Co:

Shareholder	Calculation	Voting Interest %
Jack	50 x 100 x 40	20
Jill	(50 x 100 x 40) + 10 + (60 x 50)	60
John	40 x 50	20
		100

Special Corporate Entities - Section 8C(3)(a)

Special provision for entities covered by the special corporate entity definition is necessary because these entities generally do not have share capital or shareholders that are natural persons, features on which the general loss and credit carry forward and grouping rules are predicated.

A special corporate entity is defined in section 8B to mean any:

- public authority;
- local authority;
- state-owned enterprise;
- statutory producer board;
- statutory body established by a specific statute
- Life Insurance Fund; or
- Group Investment Fund.

Where no shares have been issued by a special corporate entity, it is deemed to have issued shares in it which carry all shareholder decision-making rights. Its members or directors are deemed to hold all the shares and options over shares in it.

No breach of shareholder continuity is possible in respect of a special corporate entity or its subsidiaries, because its deemed shares are deemed to be held by the same single person.

Nominee Interests - Section 8C(3)(b)

Any voting interest held by a nominee for a person is deemed to be held by that person and not by the nominee.

A nominee is defined in section 8B as meaning any person who holds anything on behalf of, or to the order of, another person, but does not include a trustee other than a bare trust.

Under the new nominee provision, a person is no longer deemed to be the nominee of his/her spouse or child, as was the case under former section 191(1)(d). The significance of this change is that transfers of shares within a family group will potentially breach shareholder continuity except where such transfers are pursuant to a matrimonial property agreement or a disposition under a will or intestacy.

The nominee provisions will continue to require one to look to the beneficial owner of shares in determining whether continuity or commonality of shareholding requirements have been satisfied.

Shares held by discretionary trustees will not be covered by the nominee provisions and accordingly no look through rule operates in respect of discretionary trustees. As noted below, however, a general trust anti-avoidance provision in section 8E will apply to discretionary trustees.

Certain Instruments disregarded in Calculation of Voting Interests - Section 8C(3)(c) and 8B

Summary

- Certain types of instruments namely; excluded securities, pre-budget securities and excluded options (defined terms in section 8B) are not taken into account in measuring voting interests.
- "Excluded security" means any fixed rate share or section 195 debenture which does not carry any voting rights other than those that arise in protective situations only.
- "Pre-budget security" includes any section 192 and 195 debenture or fixed rate share issued before 30 July 1991.
- "Excluded option" includes an option to acquire or dispose of a share where the directors did not have actual or constructive knowledge that the option had been granted.

These instruments are also not taken into account for the purposes of the Income Tax Act provisions which are dependent on the measurement of voting interest provisions, e.g. the shareholder continuity requirements in the loss carry forward and grouping rules. However, modified definitions of excluded securities apply for purposes of the credit continuity provisions.

A section 192 debenture is one with rates of interest varying according to company profit levels.

A section 195 debenture is a debt issued in substitution for shares.

Excluded securities

An "excluded security" means any fixed rate share or section 195 debenture issued by any company which does not carry any voting rights other than those that arise only in protective situations. These protective voting rights must be essentially passive and may only be used defensively to protect a shareholder's interest in a company. The protective voting rights only include rights that:

- arise only in circumstances where the position of the holder of the share or debenture may be altered to the holder's detriment; and
- are granted to the holder of that share or debenture for the purpose of assisting that holder to prevent such alteration; and
- at the time of issue of the share or debenture the protective voting rights were not expected to arise.

Fixed rate shares or section 195 debentures which carry voting rights other than the prescribed protective rights do not qualify as excluded securities for the purposes of section 8C(3)(c), and therefore would be taken into account in the calculation of voting interests held in companies. Such fixed rate shares and section 195 debentures would consequentially also be taken into account for the purposes of, for example, the loss carry forward and grouping rules.

Pre-budget security

A pre-budget security is any section 192 and 195 debenture or fixed rate share issued before 30 July 1991, or issued after 30 July 1991 if subject to a binding contract entered into before 30 July 1991, where no term of the security or binding contract is altered after that date. Pre-budget securities can be disregarded when calculating voting interests held in a company. Pre-budget securities will not therefore retrospectively limit the carry forward of company losses.

As a result of the application of section 8C(3)(c) to section 192 and 195 debentures only:

- section 192 debentures issued after 30 July 1991; and
- section 195 debentures issued after 30 July 1991 that carry voting rights (other than protective rights)

are taken into account in calculating voting interests in a company. Any section 192 debenture issued after 30 July 1991 is taken into account as a share in determining the holder's economic interest in a company because such a debenture, with its floating rate of return (based on the profits of the company), is akin to an equity instrument.

Excluded option

An "excluded option" is also disregarded under section 8C(3)(c) when measuring voting interests held in a company.

An excluded option is one where:

- the directors of the company did not have actual or constructive knowledge that the option had been granted; or
- neither the grantor (not being the company whose shares are the subject of the option) nor any person associated with the grantor holds at the time the option is granted, any share over which the option is granted; or
- the option is granted on arm's length terms (subject to an anti-avoidance provision) and the option does not carry any voting rights (other than protective voting rights); or
- the option exercise price is set by reference to the market value of the share at the date of exercise of the option and the option does not carry any voting rights (other than protective voting rights); or
- the share over which there is an option is an excluded security (as defined in section 8B); or
- the option is over a share issued before 30 July 1991.

Market Value Interests - Section 8D

Summary

- Shareholders' market value interests in a company are measured in circumstances where their economic interests in the company are not accurately reflected by their voting interests.
- A direct market value circumstance may exist in respect of a particular company.
- An indirect market value circumstance can arise in respect of a company that is associated with a company further up a chain of companies which has a direct market value circumstance.
- A shareholder's market value interest in a company equals that person's percentage share of the total market value of shares and options held in the company.
- A person's direct market value interest in any company in a chain is deemed to equal the person's direct voting interest unless a direct market value circumstance exists in respect of that company.

Where market value circumstances exist, the shareholders' economic interests in a company must be determined by reference ***both*** to their voting interests and to their market value interests in the company.

Market value circumstance - Section 8B

A market value circumstance is defined in section 8B and exists where:

- the company has on issue a section 192 or 195 debenture (not being an excluded security or pre-budget security); or
- the company has on issue a share (not being an excluded security or pre-budget security) the payment of a dividend on which is guaranteed by a third party, and the directors of the company have actual or constructive knowledge of that guarantee; or
- an option (not being an excluded option) to acquire a share in that company exists (a call option); or
- an option (not being an excluded option) to require a person to acquire a share in the company exists (a put option); or
- an arrangement which has a purpose or effect of defeating the intent and application of any provision which is dependent upon measurement of voting and market value interests exists.

The above type of market value circumstance is referred to in section 8B as a direct market value circumstance.

A market value circumstance will not apply in respect of a company where no share or option over a share in the company has a value higher than nil. In this situation, shareholders' interests in a company will be measured solely by reference to voting interests.

It is expected, given that a market value circumstance is narrowly defined, that the application of the market value interest test will be the exception rather than the rule. ***In the vast majority of cases, it should only be necessary to apply the voting interest test.***

Indirect market value circumstance - Section 8B

If a direct market value circumstance exists in respect of a company which is in a chain of companies, paragraph (b) of the market value circumstance definition deems an indirect market value circumstance to arise in respect of every other company in the chain that is associated with that company and is below the direct market value circumstance company.

Special rules apply for the measurement of interests in an indirect market value circumstance company (section 8D(4), discussed below).

Calculation of market value interests - Section 8D(1)

A person's market value interest in a company equals his or her share of the total market value of shares and options held in the company. Market value interests include both shareholders' market value interests held directly in a company and shareholders' indirect market value interests in the same company held through interposed companies.

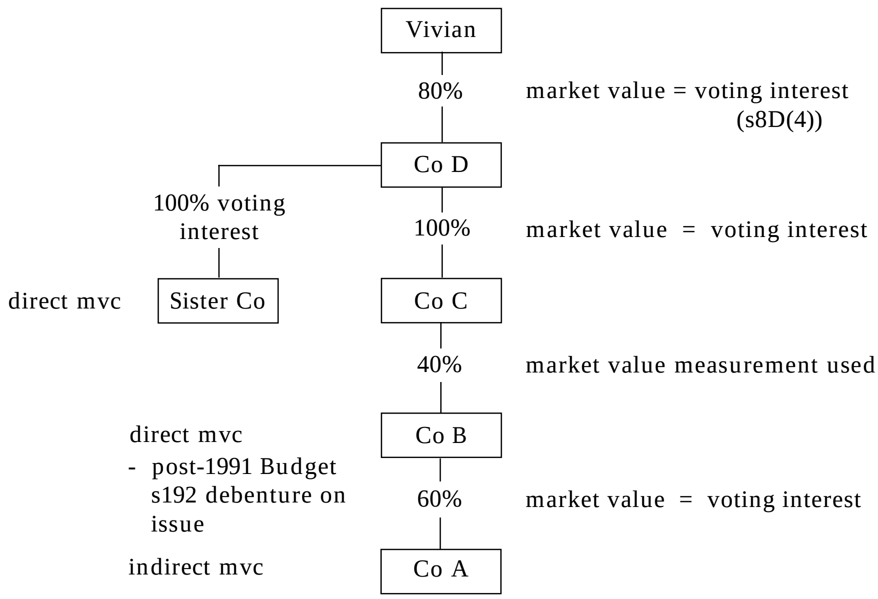
Indirect market value interests - Section 8D(3)(d) and (4)

As with voting interests, when calculating market value interests held in a company, all interests held through interposed corporate shareholders are looked through to their ultimate owners.

A shareholder's indirect market value interest in a company is aggregated with any other indirect market value interests held by that person through different chains of companies and any direct market value interest of that shareholder.

A person's direct market value interest in a company is deemed to be equal to the person's direct voting interest unless a direct market value circumstance exists in respect of that company.

Example 3: Calculation of individual's indirect market value interest



(mvc = market value circumstance)

Result: Vivian's indirect market value interest in Co A = 19.2% (80% x 100% x 40% x 60%)

Sister Co's direct market value circumstance does not affect Co C or any other company in the chain as it is not necessary to trace through Sister Co to measure ownership interests in Co A.

Determination of Market Value - Sections 8B and 8D(2)

Summary

- The market value of a share or option quoted on the official list of a recognised exchange is an amount equal to the middle market quotation at that time.
- Statutory criteria are set down for ascertaining a recognised exchange.
- Commissioner's approval that a particular market constitutes a recognised exchange can be sought.
- The market value of a non-listed share or option is the amount a willing purchaser would pay for it in an arm's length transaction.
- Some statutory guidance is given as to acceptable valuation methods.

The market value of an interest is easily determined where the company is a listed company or otherwise traded on a market. The middle market quotation method will not apply where such quotation is not a fair reflection of the market value at that time of the share or option to be valued.

Section 8B defines a recognised exchange. However the definition does not contain a list of specific exchanges. Instead, the criteria defining a recognised exchange is set down to enable taxpayers to assess for themselves whether a particular exchange constitutes a recognised exchange under that criteria.

The statutory criteria for ascertaining a recognised exchange are as follows:

- the number of participants in the market or having access to the market; and
- the frequency of trading within the market; and
- the nature of trading in the market, including how prices are determined and transactions are effected; and
- the potential or demonstrated capacity of a person to significantly influence the market; and
- any significant barriers to entry to the market; and
- any discrimination in the market on the basis of quantity bought and sold unless based on the risks involved, the transaction costs, or economies of scale.

It is also possible for a taxpayer to seek the Commissioner's approval of particular markets.

In the case of any share or option over a share not quoted on a recognised exchange, paragraph (b) of the market value definition provides that the market value of such share or option is the amount that a willing purchaser would pay to acquire that share or option in an arm's length transaction. The amount is to be determined by using a valuation method which conforms with commercially acceptable practice and results in a valuation that is fair and reasonable having regard to the tenor of sections 8B to 8F.

Some guidance regarding acceptable valuation methods is given in the market value definition, which provides that in appropriate cases regard may be had to:

- the present value at that time of the company's anticipated income or cashflows; and
- the realisable value at that time of the company's assets.

Options may affect the value of shares over which they are issued. The terms of options are therefore taken into account in the valuation of shares. However, to prevent double counting, the value of the share will exclude the value attributable to the options.

Market Value Interests: Special Corporate Entities, Nominees, and Excluded Securities/Options and Pre-Budget Securities - Section 8D(3)(a), (b) and (c)

The special corporate entity, nominee, excluded security / option and pre-budget security provisions, relating to market value interests, mirror the equivalent provisions relating to voting interests contained in section 8C which have been previously discussed. As well as being disregarded in the calculation of market value interests, excluded securities or options and any pre-budget securities (as those terms are defined in section 8B) do not in themselves trigger a market value circumstance.

Modifications to Measurement of Voting and Market Value Interests in relation to Continuity Provisions - Section 8E

Relief For Certain Transfers - Section 8E(2)

Relief from the continuity of shareholding requirements is provided for:

- transfers of shares made pursuant to a matrimonial property agreement or on the death of a shareholder. Those shares are deemed to have been acquired by the transferee on the same date those shares were acquired by the transferor.
- transfers of shares in a company under the will or intestacy of a deceased person. Those shares are deemed to have been acquired by the beneficiary or trustee of the estate on the same date those shares were acquired by the deceased person.

Where a spouse who has received shares pursuant to a matrimonial property agreement subsequently dies, then for the purposes of the continuity provisions, the beneficiary or trustee of the estate under the will or intestacy of that deceased spouse shall be deemed to have acquired the shares on the same date they were acquired by the spouse of the deceased.

Corporate Trustees - Section 8E(3)

A corporate trustee (other than the Public Trustee, Maori Trustee or a trustee company in terms of the Trustee Companies Act 1967) will be deemed to have sold any company shares it holds to a third party and immediately reacquired those shares if there is any change in the shareholding of the corporate trustee itself. The effect of this deemed sale and reacquisition is that, where a corporate trustee holds in excess of 51 percent of the shares in a loss company, there will be a breach of continuity in respect of that loss company.

The deemed sale and reacquisition of shares owned by a corporate trustee will, however, be deemed ***not*** to occur if it can be shown that the change in the corporate trustee's shareholding did not:

- change the beneficial ownership of the company shares held by the corporate trustee; or
- otherwise have a purpose or effect of defeating the intent and application of the continuity provisions.

General Trustee Anti-Avoidance Rule - Section 8E(4)

Any shares in a company held by a trustee will be deemed to be sold to a third party and immediately reacquired where there is a change in the trust's beneficiaries under an arrangement which has a purpose or effect of defeating the intent and application of the continuity provisions. For example, where a settlor is made a beneficiary under a discretionary trust, there generally will be an issue as to whether such an arrangement exists.

Shares held in Capacity of Trustee only - Section 8E(5)

Every trustee of a particular trust holds any shares or options only in their capacity as trustee of that trust.

The general corporate look through rules (sections 8C(3)(d) and 8D(3)(d)) therefore do not apply to a corporate trustee (not being a bare trustee). In other words, it is not necessary to trace the shares owned by a corporate trustee through to the shareholders of that corporate trustee. This treatment of a corporate trustee is appropriate as shares held by a corporate trustee are in substance held not so much by a "company" (which should normally be looked through) but rather are held by a trustee which happens to be a company.

A trustee's holding of shares under a particular trust is ***not*** aggregated with any shares which that trustee also holds in a capacity other than as trustee of that trust. For example, shares held in that trustee's personal capacity or in that trustee's capacity as a trustee under a different trust.

Change in identity of trustees

Changes in the identity of the trustees of the same trust will not be taken into account for shareholder continuity purposes - unless any change in the trustees has a purpose or effect of defeating the intent and application of the continuity provisions. An example of such a purpose or effect would be where the change in trustees results in a change in the beneficial ownership of the trust's assets.

Special Tracing Rules - Section 8E(6) to (9)

Summary

Special tracing rules are provided to reduce compliance costs associated with the shareholder continuity requirements.

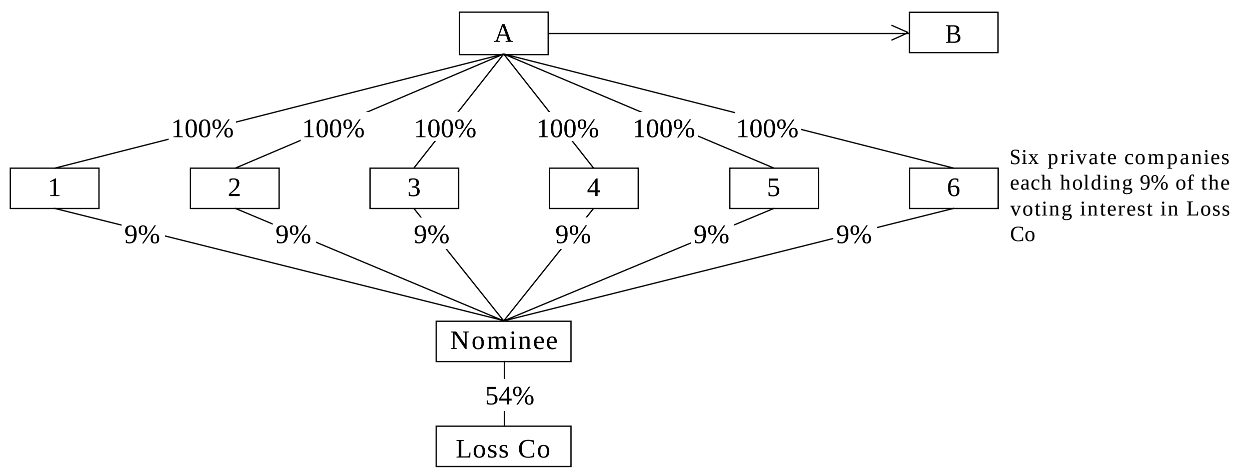
- All direct voting or market value interests of less than 10 percent are deemed not to be held separately and instead are deemed to be held by a notional single person.
- All indirect voting or market value interests of less than 10 percent are attributed to the interposed shareholder company rather than the actual shareholders.
- Corporate look through rules do not apply to certain companies (e.g. listed companies) which hold directly or indirectly less than a 50 percent voting or market value interest in a company.
- Companies using the special tracing rules have the option not to apply those rules if that would assist them in satisfying shareholder continuity requirements.
- In certain circumstances, the special tracing rules will not apply where the directors of a company had actual or constructive knowledge that a continuity provision requirement would not have been satisfied but for the special tracing rules.

Less than 10 percent direct interests - Section 8E(6) and (8)

All direct voting or market value interests of less than 10 percent are deemed not to be held separately by the actual shareholders and instead are deemed to be held by a notional single person. As a result, transfers of shares between less than 10 percent shareholders can be disregarded. This pooling concept represents a substantial modification of the general rules governing the measurement of voting and market value interests and, in particular, the general corporate look through rules (sections 8C(3)(d) and 8D(3)(d)). It is important to note that the pooling of all less than 10 percent direct interests takes place before the application of the corporate look through rules in sections 8C(3)(d) and 8D(3)(d) and, therefore, it is not necessary to look through companies which hold a less than 10 percent interest in another company.

In ascertaining whether a shareholder's direct interest in a company is less than 10 percent, the interests of associated corporate shareholders are aggregated. In the example below (which also illustrates the nominee look through rule in section 8C(3)(b)) the six companies, each holding 9 percent of the voting interests (via a nominee) in Loss Co, are "thrown out of" section 8E(6) by the application of the associated person rule in that provision. Each of the 9 percent interests is attributed to individual A, who therefore cannot use section 8E(6) to avoid a breach of continuity in Loss Co when the 54 percent interest in Loss Co is sold to B.

Example 4: Application of Associated Person Rule in section 8E(6)



When shareholders with a less than 10 percent direct interest in a company increase their interests in a company to 10 percent or more, they “fall out of” the pooling provision of section 8E(6) and need to be taken into account separately for shareholder continuity purposes.

> **Example 5** : Changes in the 10 percent pool
>
> A 6 percent shareholder acquires additional shares in the same company, which gives that shareholder a 15 percent interest. The shareholder falls out of the less than 10 percent pool. The increase in the shareholder’s interest is treated as a 15 percent change in ownership in the company, subject to the rule described in the paragraph below.

Section 8E(8) introduces a further concession of allowing less than 10 percent interests to be accounted for separately if that would assist in satisfying shareholder continuity requirements.

> **Example 6** : Changes in the 10 percent pool
>
> A shareholder increases its shareholding in a loss company from 9 to 11 percent. Without the application of section 8E(8), this increase would be treated as a 11 percent change in shareholding. The loss company, however, can account for that shareholder’s interest separately under subsection (8) from the beginning of the continuity period. The increase in the shareholder’s interest can therefore be treated as a 2 percent rather than 11 percent change in ownership in the loss company.

Less than 10 percent indirect interests - Section 8E(7)(b) and (8)

All indirect voting or market value interests of less than 10 percent are attributed to the interposed shareholder company rather than the actual shareholders.

When determining a less than 10 percent indirect interest, the rule in subsection 6 which deems a single notional person holder of less than 10 percent direct interests, is ignored.

The different indirect interests a shareholder may hold in an issuing company through different chains of companies are not aggregated in ascertaining whether a shareholder’s indirect interest in an issuing company is less than 10 percent.

This tracing concession does not apply where the shareholder with a less than 10 percent indirect interest is associated with the issuing company.

Section 8E(8) gives the issuing company the option to trace through interposed companies and attribute to the shareholders of those interposed companies their less than 10 percent indirect interests if that would assist in satisfying shareholder continuity requirements.

> **Example 7:** Tracing option
>
> Issuer Co is a wholly owned subsidiary of Parent Co. A shareholder increases his or her shareholding in Parent Co from 9 to 15 percent. In the absence of section 8E(8) this increase would be treated as a 15 percent change in ownership in the issuing company. Instead the Issuer Co can account for that shareholder’s interest separately under subsection (8) and therefore treat the shareholder’s increased interest as a 6 percent rather than 15 percent change in ownership in the issuing company.

Limited attribution companies - Section 8E(7)(a) and (8)

A limited attribution company is defined in section 8B as meaning any:

- building society ; or
- cooperative company; or
- listed company ; or
- widely-held company; or
- limited attribution foreign company.

A widely-held company is any company which has not less than 25 shareholders (treating associated shareholders as one person) and is not a closely-held company.

A limited attribution foreign company is any company which is:

- a non-resident company or a company resident in New Zealand which, pursuant to a double tax agreement (DTA), is treated as not being resident in New Zealand for the purpose of the DTA; and
- not a closely-held company.

A closely-held company is a company in which five or fewer persons (with associated shareholders being treated as one person) own, in the aggregate, over 50 percent of the direct voting interests (or, if a market value circumstance exists in respect of the company, over 50 percent of the direct market value interests) in the company.

The corporate look through rules in sections 8C(3)(d) and 8D(3)(d) also do not apply when a limited attribution company holds directly or indirectly a less than 50 percent voting or market value interest in another company.

> **Example 8** : Limited attribution company
>
> LAC Co increases its interest in Issuer Co from 49 to 51 percent. In the absence of section 8E(8) this increase would be treated as a 51 percent change in ownership in Issuer Co. Instead Issuer Co can treat its shareholding under subsection (8) as always being attributed to the shareholders of LAC Co. The change of ownership in Issuer Co is therefore treated as being only of 2 percent.

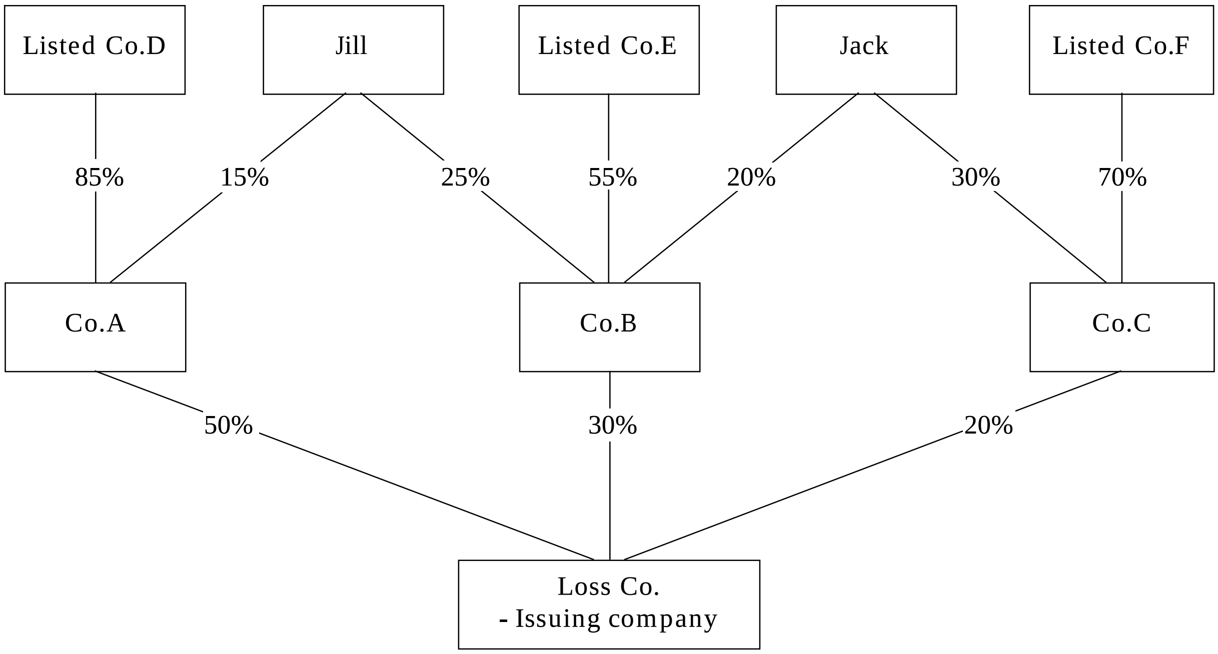
In determining the 50 percent threshold the direct interest owned by a limited attribution company in an issuing company is aggregated with any indirect interests held through different chains of companies.

Special tracing anti-avoidance provision - Section 8E(9)

Where the directors of a company know or could reasonably be expected to know that the requirements of any continuity provision would not have been satisfied but for the application of section 8E(6) or (7), that continuity provision is deemed ***not*** to have been satisfied.

This anti-avoidance provision does not apply if a breach in continuity is due solely to ordinary trading on a recognised exchange between persons with less than 10 percent interests in the company.

Example 9: Separate Treatment of each less than 10 percent indirect interest

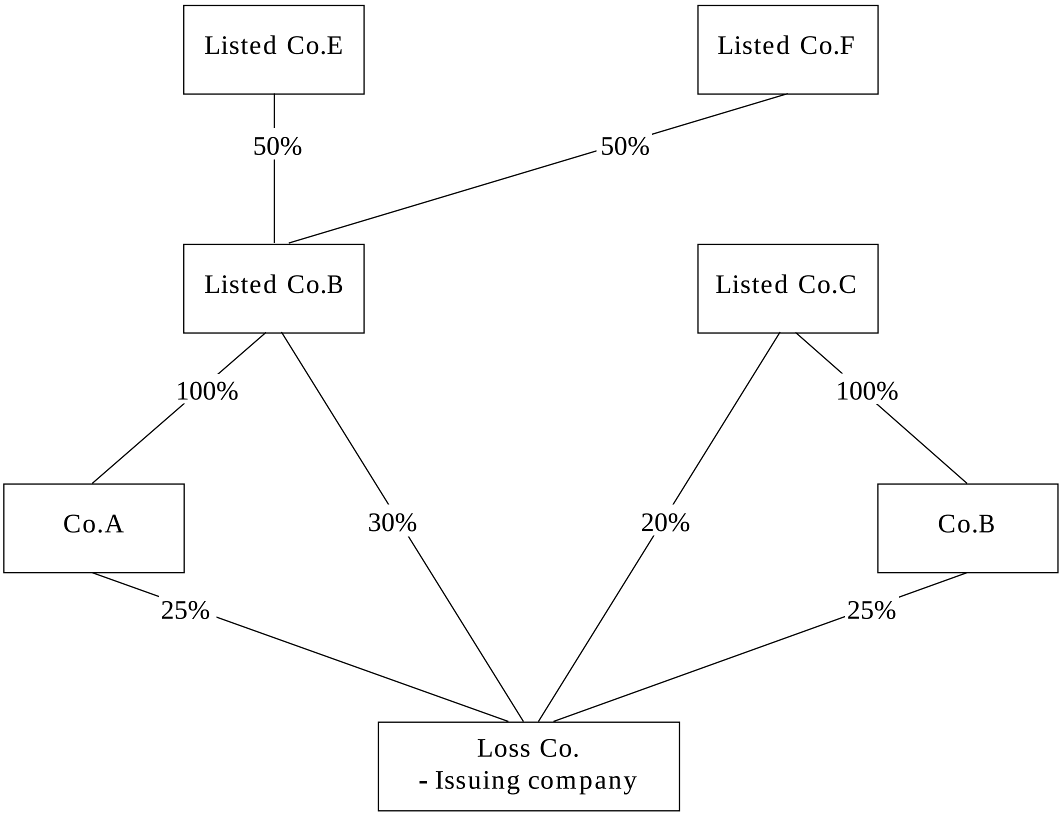


- Jack and Jill's interests are attributed to companies A, B and C even though the aggregate of each of Jack and Jill's indirect interests in Loss Co is over 10% (12% and 15% respectively); each less than 10% indirect interest treated separately (s8E(7)(b)); Jack and Jill are not associated persons
- not necessary to look through listed companies D, E and F (s8E(7)(a))
- Note: s8E(7)(b) concession would not apply if the aggregate of either Jack or Jill's interests were increased beyond 25% because they would then be associated with Loss Co (s8E(7)(a)(i)).

Voting interests in Loss Co

	%
Co.A	7.5
Co.B	13.5
Co.C	6.0
Listed Co.D	42.5
Listed Co.E	16.5
Listed Co.F	14.0
	100.0

Example 10: Aggregation of direct and indirect interests held by a limited attribution company

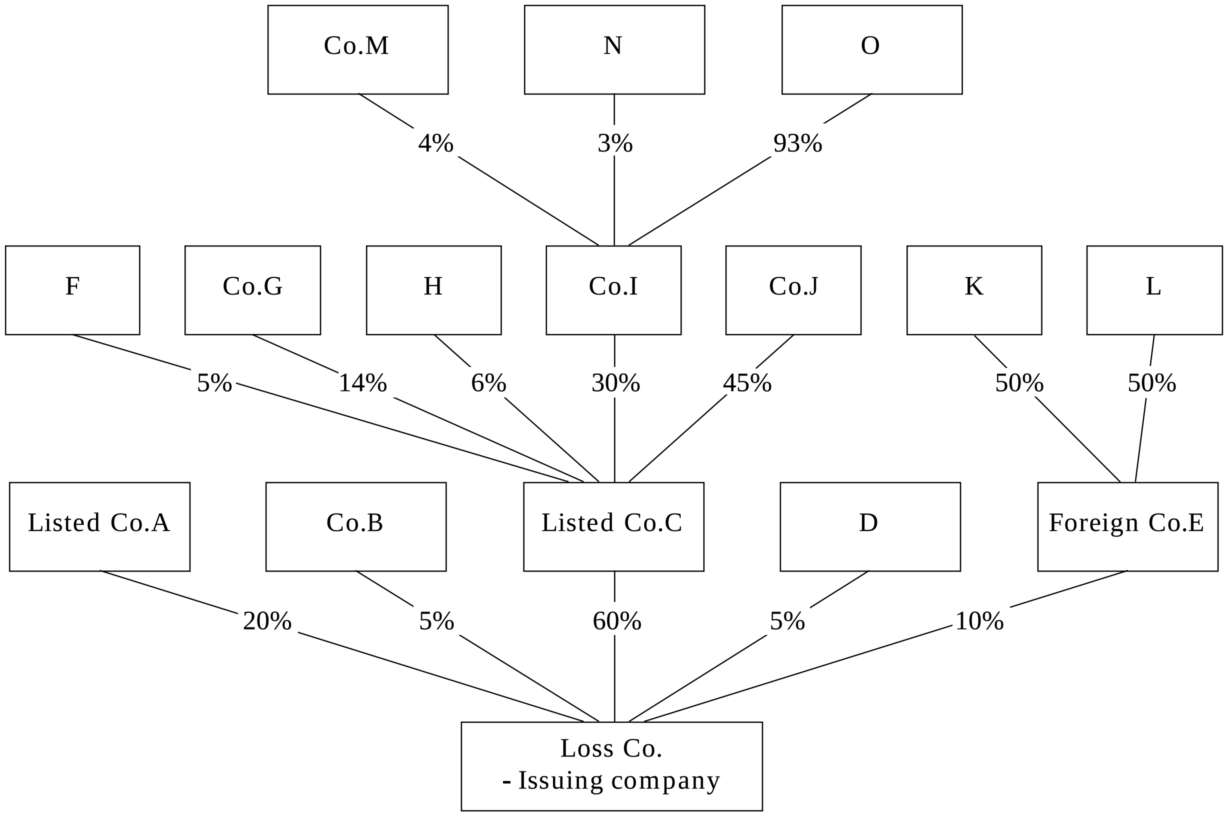


- listed Co.B is treated as holding a 55% interest in Loss Co; listed Co.B's 30% direct interest in Loss Co is aggregated with Co.B's 25% indirect interest in Loss Co held through Co.A
- because listed Co.B's 55% interest in Loss Co breaches the less than 50% threshold in s8E(7)(a) it is necessary to look through B to its shareholders
- not necessary to look through listed companies E and F as they each hold less than a 50% interest in Loss Co; for the purposes of this example only listed Co.B is deemed to have sufficient shareholders
- while it is necessary to aggregate listed Co.C's 20% direct interest in Loss Co with Co.C's 25% indirect interest in Loss Co held through Co.D, it is not necessary to look through listed Co.C itself because it holds less than a 50% interest in Loss Co (s8E(7)(a))

Voting interests in Loss Co

	%
Listed Co.E	27.5
Listed Co.F	27.5
Listed Co.C	45.0
	100.0

Example 11: Application of special tracing rules

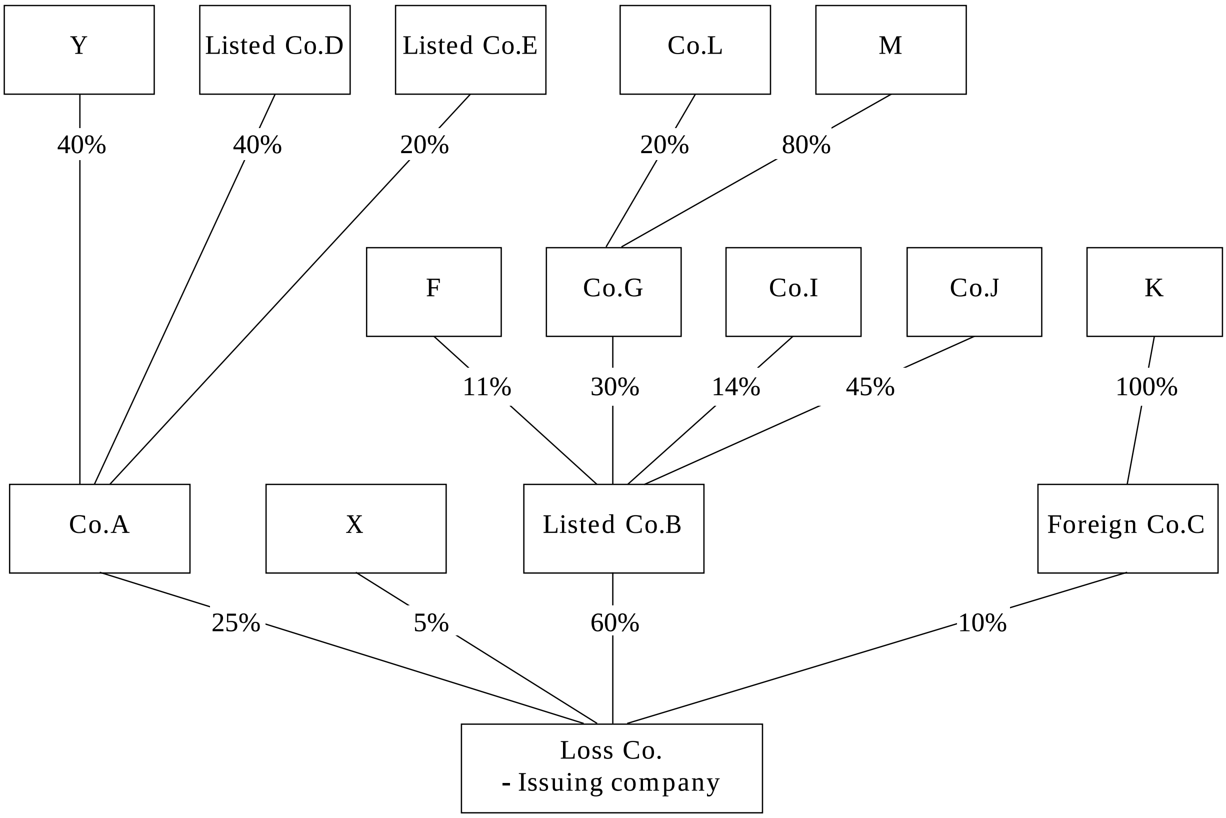


- No market value circumstance exists in respect of any company
- D, F, H, K, L, N and O are natural persons; all others are companies
- Listed companies A and C are limited attribution companies (LAC), but have to look through C generally because it has a greater than 49% interest in Loss Co (s8E(7)(a)); for the purposes of this example only listed Co.C is deemed to have sufficient shareholders
- Foreign Co.E is a closely held company and therefore not a limited attribution foreign company (i.e., a LAC), but still don't have to look through E because K and L each have a less than 10% indirect interest in Loss Co (s8E(7)(b))
- Co.B and D are less than 10% direct interest holders in Loss Co and therefore join the public pool (s8E(6))
- Look through Co.I under normal corporate look through rule (s8C(3)(d))
- Because F, Co.G and H have less than 10% indirect interests in Loss Co their interests are attributed to listed Co.C (s8E(7)(b))
- Because Co.M and N have less than 10% indirect interests in Loss Co their interests are attributed to Co.I (s8E(7)(b))

Voting interests in Loss Co

	%
Listed Co.A	20.00
Foreign Co.E	10.00
Listed Co.C	15.00
Public pool	10.00
Co.J	27.00
Co.I	1.25
O	16.75
	100.00

Example 12: Application of special tracing rules



- No market value circumstance exists in respect of any company
- X, Y, F, k and M are natural persons; all others are companies
- Foreign Co.C is a closely held company and therefore not a limited attribution foreign company; need to look through to K
- Co.A is not a limited attribution company (LAC), therefore normal corporate look through rule (s8C(3)(d)) applies
- Because X is a less than 10% direct interest holder in Loss Co, its interest is attributed to the public pool (s8E(6))
- Listed Co.B is a limited attribution company (LAC), but have to look through because it has a greater than 49% interest in Loss Co (s8E(7)(a)); for the purposes of this example only listed Co.B is deemed to have sufficient shareholders
- Because listed Co.E has a less than 10% indirect interest in Loss Co its interest is attributed to Co.A (s8E(7)(b))
- Listed Co.D is a LAC, therefore no look through
- Because F and Co.I have less than 10% indirect interests in Loss Co their interests are attributed to listed Co.B (S8E(7)(b))
- Look through Co.G under normal corporate look through rule (s8C(3)(d))
- Because Co.L has a less than 10% indirect interest in Loss Co its interest is attributed to Co.G (S8E(7)(b))
- Co.J is a widely held company (i.e., a LAC), therefore no look through (s8E(7)(a))

Voting interests in Loss Co

	%
Co.A	5.0
Listed Co.D	10.0
Y	10.0
Public pool	5.0
K	10.0
Listed Co.B	15.0
Co.J	27.0
Co.G	3.5
M	14.5
	100.0

Change In Market Value Of Company Assets - Section 8E(10)

Any change in a shareholder's market value interest in a company can be disregarded for continuity provision purposes to the extent that the change is solely attributable to a change in the market value of the company's assets or to a change in the market value of the company's shares which is not attributable to any change in the terms of those shares.

Modifications to Measurement of Voting and Market Value Interests in case of Credit Account Continuity Provisions - Section 8F

The general measurement of voting and market value interest rules are modified for the credit account continuity provisions, that is, the imputation credit account, dividend withholding payment account, and branch equivalent tax account provisions.

For the purposes only of the credit account continuity provisions the following post-Budget instruments are taken into account in measuring voting and market value interests held in a company :

- fixed rate shares ;
- section 192 and 195 debentures.

Any option to acquire or dispose of such a fixed rate share or section 195 debenture is also taken into account.

Fixed rate shares falling within paragraph (a)(ii) of the definition of "market value circumstance", certain options over shares and the issue of section 192 / 195 debentures are market value circumstances for purposes of the credit continuity provisions

Part 3A - Loss Carry Forward Rules

Introduction

Section 22 repeals section 188 and substitutes a new section 188.

The new section 188 utilises the new measurement of ownership interests in a company, inserted by *section 7*.

The main changes from former section 188 are as follows:

- a purpose provision is inserted for the first time in the loss carry forward rules;
- the minimum continuity of shareholding which must be maintained at all times during a continuity period for a company to carry forward its losses has increased from 40 percent to 49 percent;
- the lowest percentage voting or market value interest held by each shareholder during the continuity period is used to determine whether the shareholding continuity requirements have been satisfied.
- where shareholder continuity is breached during an income year, losses can be carried forward and set off against any current part year profit attributable to the period before the change of ownership.

The new section 188 applies from the 1992-93 income year.

Purpose of Section 188 - Subsection (1)

The purpose of the loss carry forward rules is to permit companies to carry forward and set off a loss only where the tax benefit arising from such set off is obtained, at least to the extent of 49 percent, only by the same natural persons who effectively bore the loss through their shareholdings.

General provisions - subsections (2) to (5)

- The amount of any loss incurred by a taxpayer in any income year is determined under the Act;
- There is no time limit on carrying forward a loss for set off against assessable income derived in subsequent income years.
- A $10,000 limitation applies to losses incurred in certain specified activities before the 1991 income year (section 188A).
- Where a taxpayer carries forward losses incurred in two or more income years, those losses must be set off against assessable income in the order they were incurred.
- Where, if a profit had been made from the transaction in which the loss was incurred, the amount of the profit would not have been assessable income, that loss cannot be carried forward under section 188.

Loss Adjustment For Debt Remission - Subsection (6)

Section 188(5) deals with the situation where a debt, which has been taken into account in calculating a loss incurred by a taxpayer in an income year, is subsequently remitted or becomes irrecoverable. The loss previously calculated is required to be adjusted so as to exclude the amount of any debt which has been remitted or becomes irrecoverable. The various circumstances in which a debt is remitted or cancelled for the purposes of subsection (6) are set out in paragraph (c) of that subsection.

The loss adjustment provisions do not apply where the remission or cancellation of a debt is taken into account under the accrual rules.

For the purposes of giving effect to subsection (6), the Commissioner may at any time alter any assessment notwithstanding the four year time limit for amendment of assessments in section 25 of the Income Tax Act.

General Rule for Carrying Forward of Losses by Companies - Subsection (7)

Summary

- a 49 percent continuity of minimum voting interests needs to be maintained by a group of persons at all times during the continuity period;
- the same group of persons must also maintain 49 percent continuity of minimum market value interests if the loss company has a market value circumstance;
- the lowest percentage voting or market value interest held by each shareholder during the continuity period is used to satisfy shareholder continuity requirements;

A company can only carry forward its losses if at all times during the period from the beginning of the year of loss to the end of the year of carry forward (the continuity period), a group of persons held, in aggregate, at least 49 percent of the minimum voting interests in the company. If at any time during the continuity period a market value circumstance exists in respect of the loss company, the same group of persons must **also** hold at least 49 percent of the minimum market value interests in the loss company throughout that continuity period.

Minimum voting or market value interest

The lowest percentage voting interest or market value interest (where a market value circumstance exists) held by each shareholder during the continuity period is used to determine whether the shareholding continuity requirements have been satisfied. A breach of continuity can therefore potentially take place where the number and identity of a loss company's shareholders does not change during a continuity period, but the proportion of shares held by each shareholder does.

Example 1: Application of minimum voting or market value interest rule

- Standard balance date company incurs loss in 1992-93 income year;
- Shareholding proportions equivalent to voting or market value interest percentages;
- Shareholding changes on 31.06.93

Shareholder	Loss Company Shareholding 1.04.92	Loss Company Shareholding 31.06.93	Lowest Percentage
	%	%	%
A	20	60	20
B	80	10	10
C	-	30	-
	100%	100%	30%

Result: 49% test breached (minimum continuity = 30%)

Loss company cannot carry forward loss (incurred in 1992-93 income year) to the 1993-94 income year.

Part Year Loss Carry Forward - Subsection (8)

Where there has been a breach of shareholder continuity part way through a company's current income year, a loss incurred by the company which is attributable to the part period of the income year after the change in shareholding may be carried forward by the company.

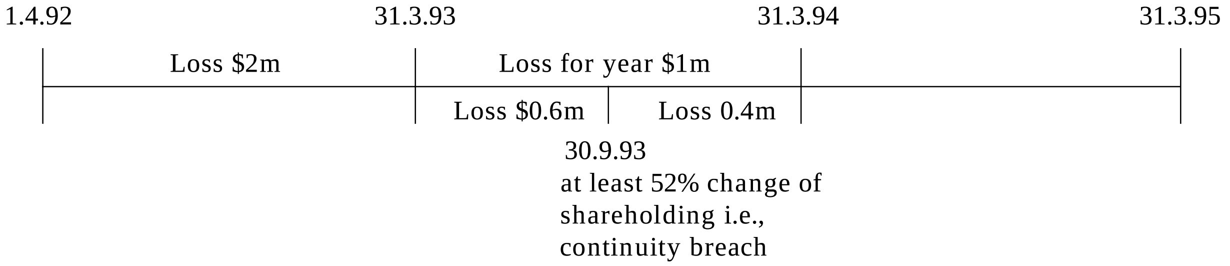
The relief from the general shareholder continuity requirements in subsection (7) only applies to the relevant current part year loss period and does not extend to later periods (i.e. subsequent carry forward years).

Adequate accounts must be furnished to the Commissioner showing the amount of loss reasonably and fairly attributable to that part year.

Subsection (8) will also apply where companies are formed part way through an income year and incur a loss in the period to the end of that income year.

Example 2: Application of part year loss carry forward rule

Standard balance date loss company



Result: Loss carried forward to 1994 income year - nil
Loss carried forward to 1995 income year - $0.4m

Setting Off Carried Forward Losses Against Current Part Year Profits - Subsection (9)

Where shareholder continuity is breached during an income year, previous year losses can be carried forward to that income year and set off against any current part year profit that is attributable to the period before the change in shareholding.

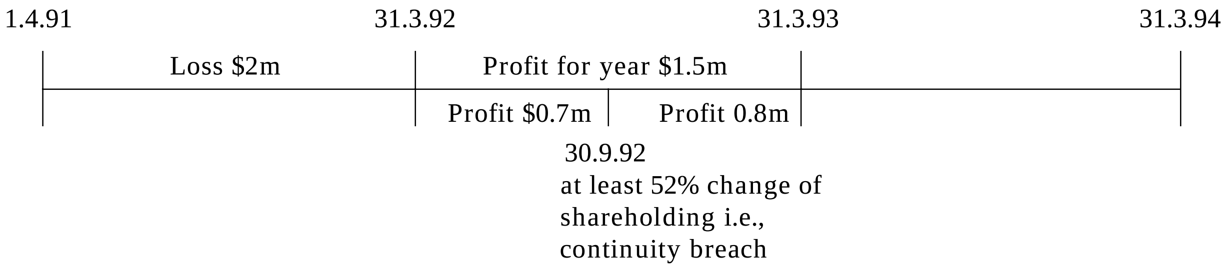
The relief from the general shareholder continuity requirements in subsection (7) only applies to the relevant current part year profit period and does not extend to earlier periods (i.e. the year of loss and any intervening carry forward years).

Any loss incurred in income years prior to the 1992-93 income year can be carried forward and set off against any current part year profit derived in the 1992-93 and subsequent income years. This part year profit set off rule has not previously been included in the loss carry forward rules.

In order to gain the benefit of subsection (9), a company must provide adequate accounts to the Commissioner that relate to the part year of profit and detail the amount of profit reasonably and fairly attributable to that part year.

Example 3: Application of part year profit set off rule

Standard balance date loss company



Result: Loss carried forward to 1993 income year - $0.7m
Loss carried forward to 1994 income year - nil

Anti-Avoidance Provision - Subsection (11)

The anti-avoidance provision applies where:

- any shares in the loss company or in any other company have been subject to an arrangement; or
- shares in the loss company or in any other company have had any rights attaching to them extinguished or altered by any means whatsoever.

Land and Income Tax Act 1954 Transitional Provision - Subsection (12)

Subsection (12) provides for a transition between the loss carry forward provisions of the Land and Income Tax Act 1954 (section 137) and the loss carry forward provisions of the Income Tax Act 1976.

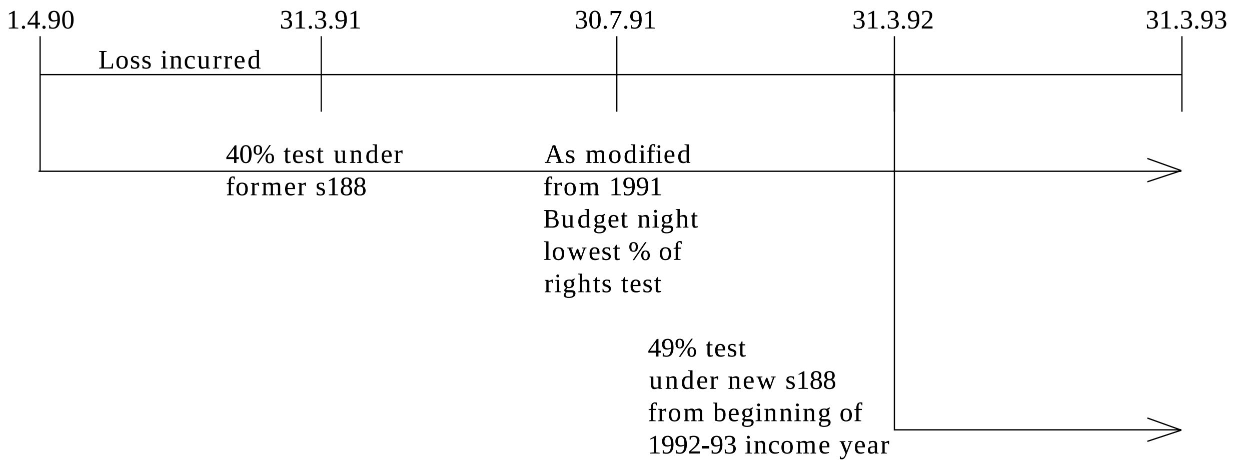
Loss Carry Forward Transitional Rules - Subsection (13)

Losses incurred by a company in the 1991-92 and prior income years which do not meet the new continuity requirements from the beginning of the year of loss may carry forward those losses to the 1992-93 and subsequent income years if the following dual test is satisfied:

- the 40 percent continuity test applicable as from the 1991 Budget night is satisfied from the beginning of year of loss until the end of the year of loss utilisation. From the 1991 Budget night the lowest percentage of rights held by each shareholder in a company is taken into account.; and
- a 49 percent continuity of shareholding, computed using the new rules from the beginning of the loss company's 1992-93 income year until the end of the year of loss utilisation.

Example 4: Section 188(13) application to loss incurred by standard balance date company in 1990-91 income year

- Standard balance date loss company
- Loss carried forward to 1993-94 and subsequent income years until utilised



Non-Standard Accounting Year - Subsection (14)

The term "income year' means a corresponding accounting year where a taxpayer has a non-standard accounting year.

Part Year Loss Carry Forward of 1990-91 and 1991-92 Losses - Section 188AA

Section 23 inserts a new section 188AA in the Income Tax Act relating to the part year carry forward of losses incurred by companies in the 1990-91 and 1991-92 income years.

Under former section 188(7B), in determining continuity of shareholding between 30 July 1991 and the end of the 1991-92 income year, the lowest number of shares held during that period is deemed to be held at all times during that period for shareholder continuity purposes. It also had the unintended effect of preventing the carry forward of part year 1990-91 and 1991-92 losses incurred by companies formed after 30 July 1991 or incurred by existing companies after 30 July 1991 following a breach in shareholder continuity.

Section 188AA corrects the situation, by allowing such companies the carry forward from the 1990-91 and 1991-92 income years of part year losses.

The loss company is required to prepare and furnish to the Commissioner adequate accounts that relate to the part year of loss and detail the amount of loss reasonably and fairly attributable to that part year.

Losses of Mining Companies and Petroleum Miners - Section 188C

Section 24 inserts a new section 188C relating to losses of mining companies and petroleum miners. The only purpose of new section 188C is to separate out from new section 188 the mining provisions previously contained in subsections (9) and (9A) of former section 188.

Special Partnerships - Section 211B

Section 30 amends section 211B of the Income Tax Act, which relates to special partnerships, to provide that a claim for a loss carry forward by a special partnership will not be allowed unless the Commissioner is satisfied that:

- if the partnership had been a company; and
- the interests of the partners in the partnership's certified capital had been shares in the company the loss could have been carried forward to a later income year in accordance with new section 188.

The criteria for the carry forward of losses is therefore the same for both special partnerships and companies.

Part 3B - Loss Grouping Rules

Introduction

Section 25 repeals former section 191, which related to groups of companies and the circumstances in which one company may claim a deduction for the losses of another company, and substitutes new sections 191 and 191A.

New section 191 sets out the general purpose of the company grouping and loss offset provisions and, in particular, the circumstances where two or more companies are treated as a group of companies.

New section 191A sets out the circumstances where losses can be offset within groups of companies.

The new company grouping and loss offset provisions utilise the new measurement of ownership provisions.

The substantive effect of many of the provisions in new sections 191 and 191A is similar to that of former section 191. There are, however, several important differences which are set out below:

- under the new grouping and loss offset rules, loss and profit companies must be members of the same group ***at all times*** from the beginning of the loss company's income year in which the loss is incurred to the end of the year of offset;
- the specified group / ordinary group distinction is removed;
- the means by which corporate groups actually offset losses are simplified under the new rules. Groups of companies are able to offset the losses and profits of member companies against each other by a combination of subvention payments and elections;
- part year grouping of losses is permitted.

The new loss offsetting rules are designed to restrict the ability of companies which are not members of the loss source group from benefiting from those tax losses.

The new company grouping and loss offset rules contained in sections 191 and 191A apply from the 1992-93 income year.

Company Grouping - Section 191

Summary

- Two or more companies may be treated as a group of companies at a particular time.
- Two or more companies may be treated as a group of companies for an income year.
- Every company in a group of companies is liable for income tax as if it were a company not included in a group of companies.
- Income is deemed assessable to a company in a wholly-owned group of companies if the wholly-owned group had been treated as one company.
- A group of companies may apply to be jointly assessed.

Group of companies at a particular time - Subsection (3)(a)

In relation to two or more companies, where at any time the aggregate of the common voting interests is at least 66 percent, those companies shall be treated as a group of companies at that time. The common voting interest is equivalent to the lowest percentage voting interest of each shareholder in each of those companies at a particular point of time.

Where a market value circumstance exists in respect of any of the relevant companies, the aggregate of the common market value interests must **also** be at least 66 percent. The common market value interest is equivalent to the lowest percentage market value interest of each shareholder in the relevant companies at a particular point in time.

Group of companies for an income year - Subsection (3)(b)

In relation to two or more companies, where ***at all times*** during an income year the aggregate of the common voting interests is at least 66 percent, those companies shall be treated as a group of companies for that income year. The common voting interest is equivalent to the lowest percentage voting interest of each shareholder in each of those companies at a particular point in time.

Where a market value circumstance exists in respect of any of the relevant companies, the aggregate of the common market value interests must **also** be at least 66 percent. The common market value interest is equivalent to the lowest percentage market value interest of each shareholder in the relevant companies at a particular point in time.

Whereas under former section 191 a group of companies' status was only tested at two points in time (31 March in the year of loss and 31 March in the year of offset), new section 191 requires the 66 percent commonality to be maintained at all times from the commencement of a loss company's income year in which the loss is incurred to the end of the loss company's income year in which the loss is offset.

Example 1: Application of group of companies for an income year test

- Companies A to F are all standard balance date companies
- There is no change of shareholding during the income year
- A market value circumstance exists, viz s192 debenture on issue (issued after 30 July 1991)
- Shareholding proportions are equivalent to voting and market value interest percentages

Shareholder	**Company A**	**Company B**	**Company C**	**Common Voting or Market Value Interests**
	%	**%**	**%**	**%**
1	30	20	20	20
2	30	40	30	30
3	40	40	50	40
	100	100	100	

Aggregate of Common Voting or Market Value Interests 90%

Result: Companies A, B and C qualify as a group of companies for the income year

Example 2: Application of group companies for an income year test

- Same facts as in example 1

Shareholder	**Company D**	**Company E**	**Company F**	**Common Voting or Market Value Interests**
	%	**%**	**%**	**%**
1	60	10	50	10
2	10	50	10	10
3	30	40	30	30
	100	100	100	

Aggregate of Common Voting or Market Value Interests 50%

Result: Companies D, E and F do not qualify as a group of companies for the income year

Wholly-Owned Group Of Companies - Subsection (4)

A wholly owned group is defined as two or more companies where the aggregate of the common voting interests or common market value interests, as the case may be, is 100 percent. The definition is used, for example, for purposes of the interim inter-corporate dividend exemption.

Company Liable As If Not A Member Of A Group - Subsection (5)

Every company in a group of companies is assessable and liable for income tax as if it were a company not included in a group of companies. This provision ensures that special provisions of the Act, relating to certain taxpayer companies (e.g. mining companies and life insurance companies), are still applicable in determining the assessable income of those companies.

Income Deemed Assessable To Company If Group Treated As One Company - Subsection (6)

Where profits or gains are derived by a company in a wholly-owned group, those profits and gains are deemed to be assessable if they would have been assessable income had the wholly- owned group been treated as one company. This is an anti-avoidance provision.

Joint Assessment Of Group Income - Subsection (7)

The Commissioner may, on written application by or on behalf of all the companies in a wholly-owned group, make a joint assessment of the income tax payable in respect of the income derived by the group member companies in an income year. Any such single return of group income will need to be signed by a group company officer duly authorised by all the companies in the wholly-owned group.

Each member company of a group of companies in respect of which a joint assessment has been made is separately liable for the tax for which it would have been liable if each company had been assessed separately.

Non-Standard Accounting Year - Subsection (8)

Every reference in section 191 to an income year is a reference to the accounting year corresponding with that income year where a taxpayer has a non-standard accounting year.

Loss Offset between Group Companies - Section 191A

General rules - subsection (1)(a), (b) and (c) :

The amount of any loss available for offset is determined under the Act.

Group offset of losses is permitted only where, in addition to satisfying the minimum 66 percent commonality of ownership test, the continuity of ownership test is also satisfied.

If a profit made from the transaction in which the loss was incurred would not be assessable income, no offsetting deduction is allowed.

Loss Offsetting Machinery: General Rules - Subsection (2)

Summary

- a group of companies has the option of offsetting its losses by either subvention payment or election;
- the amount of loss offset is restricted to the lesser of a profit company's profit or a loss company's loss;
- a loss company and a profit company must be members of the ***same*** group ***at all times*** from the beginning of the loss company's income year in which the loss is incurred to the end of the year of offset;
- only non-dual resident companies incorporated in New Zealand and non-residents carrying on business in New Zealand through a fixed establishment (to the extent of that branch's losses) may offset losses;
- A loss company must maintain shareholding continuity during the year of offset;
- The amount of any loss offset (whether by way of subvention payment or election) is assessable to the loss company and deductible to the profit company in the year of offset.

Losses available for offset within a group - subsection (2)(a)

The losses eligible for offset within a group in the year of offset are:

- current year losses incurred by a loss company in the income year of offset; and
- prior year losses incurred by a loss company which are eligible to be carried forward under section 188 to the income year of offset.

Method of offset - subsection (2)(b)

Subject to the loss offsetting requirements in subsection (2) being satisfied, company losses can be offset by either election or subvention payment.

The loss company has the option to either:

- elect by notice in accordance with section 191A(3) that the whole or part of its loss be deducted from the assessable income derived in the year of offset by a profit company (any such election to be irrevocable); or
- receive a subvention payment from a profit company under an agreement providing for the profit company to bear or share in the loss company's loss.

Commonality of ownership requirements - subsection (2)(c)

To offset a loss incurred during a current income year, the loss company and the profit company must be members of the same group for that income year.

To offset a carried forward loss, the loss company and the profit company must be members of the same group of companies for the entire period beginning with the income year in which the loss is incurred and ending with the year of offset.

Where the profit company has a later balance date than the loss company in the year of offset, both companies must be members of the same group until the end of the profit company's income year corresponding to the year of offset.

Offsetting of losses available to certain companies only - Subsection (2)(d)

Loss grouping will only be available in respect of the losses of:

- companies that are incorporated in New Zealand and which are not dual resident companies; or
- companies (which are not dual resident companies) that are carrying on business in New Zealand through a fixed establishment, i.e. a New Zealand branch of a non-resident company.

The combined effect of this provision and section 191A(1)(c) is that non-resident companies are only able to offset their losses to the extent of the losses of their New Zealand branches.

Continuity of ownership requirements - Subsection 2(e)

A loss company is required to maintain continuity of ownership during the year of offset. Where the balance date of the profit company is later than the balance date of the loss company, the loss company will have to maintain shareholder continuity until the end of the profit company's accounting year before its loss can be offset against the assessable income of the profit company.

Loss offset not to exceed assessable income of profit company - Subsection (2)(f)

The amount of a loss offset (whether by way of subvention payment or election) cannot exceed the amount of assessable income derived by the profit company in the year of offset.

Example 3

In the year of offset, Loss Co had $200 of losses (comprised of losses incurred in the year offset and losses carried forward to that year) available to offset . Profit Co derived $100 of profits. The amount of the loss offset is limited to a maximum of $100. Therefore, it is not possible to transform a profit company into a loss company by means of the loss offset.

Subvention payment requirements - Subsection (2)(g)

First, the amount of the subvention payment must not exceed the amount of the loss company's loss.

Example 4

In the year of offset Loss Co had $100 of losses available to offset and Profit Co had derived $200 of profits. The amount of the subvention payment is restricted to a maximum of $100; therefore, the subvention payment therefore cannot constitute the whole of the profit company's profit. Therefore, it is not possible to transform a loss company into a profit company by means of the subvention payment.

Second, the subvention payment must be made:

- not later than the 31st day of March that, in relation to the year of offset, is the latest date to which the time for the furnishing of the loss company's return may be extended under section 17(6) of the Income Tax Act; or
- within such further time as the Commissioner may allow.

Third, the subvention payment must not be a payment that would otherwise than under section 191A(2) be taken into account in calculating the assessable income of either the loss company or the profit company.

Fourth, the loss company is required to give notice to the Commissioner of any subvention payment it receives.

Amount of loss offset deductible by profit company - Subsection (2)(h)

The amount of any loss offset (whether by way of election or subvention payment) is deductible by the profit company in the year of offset as if it were expenditure necessarily incurred in the production of assessable income during that year.

Amount of loss offset assessable to loss company - Subsection (2)(i)

The amount of any loss offset (whether by way of election or subvention payment) is deemed to be assessable income derived by the loss company in the year of offset.

Subvention payment not a dividend - Subsection 2(j)

Any subvention payment made by a profit company shall not be treated as a dividend paid by the profit company to the loss company.

Loss Offset Notice Requirements - Subsection (3)

Notices are required under section 191A(2) to be given to the Commissioner by the loss company where it:

- either elects that the whole or part of its loss be deducted from a profit company's assessable income derived in the year of offset; or
- receives a subvention payment from a profit company.

Every notice under subsection (2) is required to be given in writing and shall be given to the Commissioner:

- not later than the 31st day of March that, in relation to the year of offset, is the latest date to which the time for the furnishing of the loss company's return may be extended under section 17(6) of the Income Tax Act; or
- within such further time as the Commissioner may allow.

Part Year Grouping - Subsections (4) and (5)

Summary

- Situation of loss or profit company sold or formed during an income year addressed.
- Reciprocal situation of vendor or purchaser/subscriber group also addressed.
- Part year grouping only allowed in relation to period where loss company maintains shareholder continuity and commonality of shareholding between loss and profit companies is maintained.
- Part year grouping is subject to the provision of adequate accounts.

The general part year grouping rule is that only that part of the loss that is incurred in the same period as the profit is derived may be offset provided during that period:

- the loss company maintains continuity of shareholding; and
- commonality of shareholding between loss and profit companies has been maintained.

Therefore, loss and profit "caps" (i.e. amounts allowed to be offset) are based on periods where continuity and commonality requirements are satisfied in respect of all companies participating in a part year grouping arrangement.

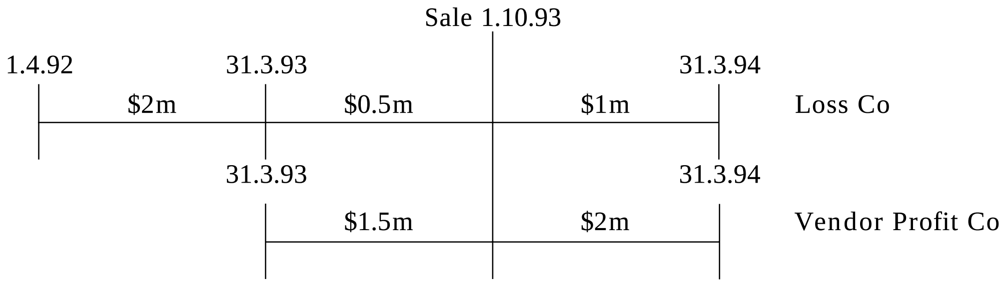
Loss company sold or formed during income year

1 Pre-sale carried forward and current part year losses

The carried forward and pre-sale current part year loss of the loss company may be offset against the pre-sale current part year profit of the vendor group.

Example 4

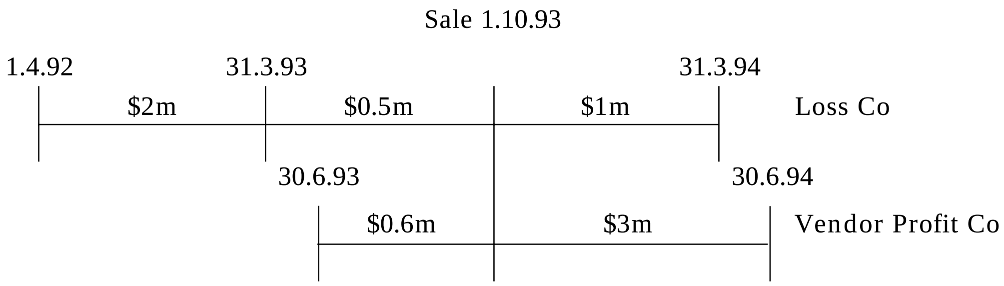
Same balance date companies



Result: Amount of loss offset between loss company and vendor profit company limited to $1.5m

Example 5

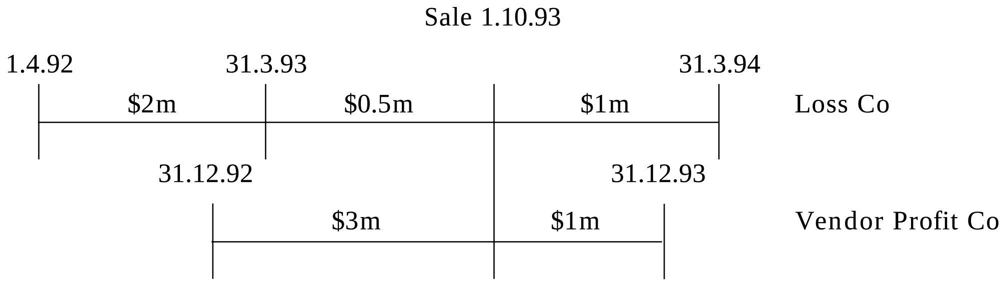
Vendor Profit Company has later balance date



Result: Amount of loss offset between loss company and vendor profit company limited to $0.6m

Example 6

Vendor Profit Company has earlier balance date



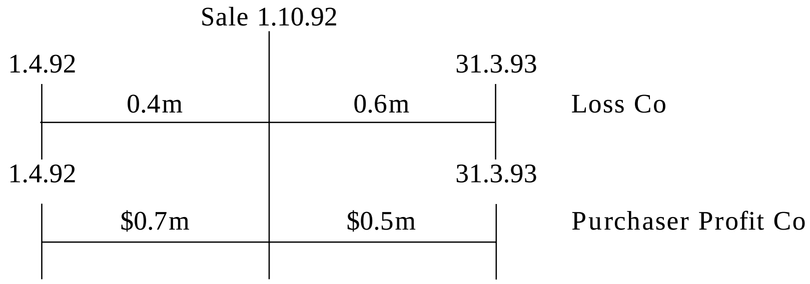
Result: Whole $2.5m of carried forward and pre-sale current part year loss can be offset

2 *Post-sale/formation current part year loss*

The post-sale / formation current part year loss of the loss company may be offset against the post-sale / formation current part year profit of the purchaser / subscriber group.

Example 7

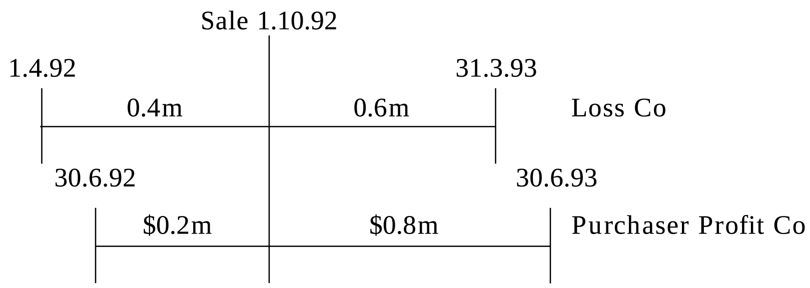
Same balance date companies



Result: Amount of loss offset between loss company and purchaser profit company limited to $0.5m

Example 8

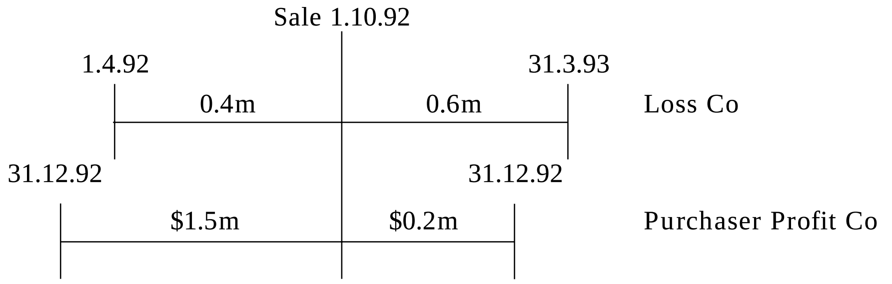
Purchaser Profit Company has later balance date



Result: Whole $0.6m of post-sale current part year loss can be offset.

Example 8

Purchaser Profit Company has later balance date



Result: Amount of loss offset between loss company and purchaser profit company limited to $0.2m.

Profit company sold or formed during income year

1 *Pre-sale part year profit*

The pre-sale current part year profit of a profit company may be offset against the carried forward and pre-sale current part year loss of the vendor group.

2 *Post-sale/formation part year profit*

The post-sale / formation current part year profit of a profit company may be offset against the post-sale / formation current part year loss of the purchaser / subscriber group.

Part year grouping situation for vendor group

Section 191A(5), which relates to carried forward losses, is only relevant to the part year grouping situation of vendor groups.

1 *Sale of loss company during income year*

The vendor group may offset its pre-sale current part year profit against the carried forward and pre-sale current part year loss of the loss company.

2 *Sale of profit company during income year*

The vendor group may offset its carried forward and pre-sale current part year loss against the pre-sale current part year profit of the profit company.

Part year grouping situation for purchaser/subscriber group

1 *Sale/formation of loss company during income year*

The purchaser / subscriber group may offset its post-sale / formation current part year profit against the post-sale / formation current part year loss of the loss company.

2 *Sale/formation of profit company during income year*

The purchaser / subscriber group may offset its post-sale / formation current part year loss against the post-sale / formation current part year profit of the profit company.

Part year grouping matrix

	Vendor group s191A(4) and (5)	**Purchaser group s191A(4)**
Loss company sold during income year	carried forward and pre-sale part year loss offset against pre-sale part year profit of vendor group	post-sale / formation part year loss offset against post-sale / formation part year profit of purchaser / subscriber group
Profit company sold during income year	pre-sale part year profit offset against carried forward and pre-sale part year loss of vendor group	post-sale / formation part year profit offset against post-sale / formation part year loss of purchaser / subscriber group

Dual Resident Company Definition - Subsection (6)

Under section 191A(2)(d) a dual resident company cannot utilise the loss offsetting provisions. A dual resident company itself is defined as any company which is:

- resident in New Zealand; and
- either -
  - treated pursuant to a double tax agreement (DTA) as not being resident in New Zealand for the purpose of the DTA; or
  - liable to income tax in another country or territory by reason of domicile, residence or place of incorporation.

Anti-Avoidance Provision - Subsection (7)

A deduction for a loss offset shall not be allowed in calculating the assessable income of any company where any shares in that company or in any other company have:

- been subject to an arrangement; or
- have had any rights attaching to them extinguished or altered by any means whatsoever for the purpose of enabling a company to meet the requirements of subsection (2) so as to defeat the intent and application of section 191A.

> **Example 10:** Arrangement vulnerable to anti-avoidance provision
>
> All the shares in a prospective loss company are transferred prior to the income year in which that company starts to make a loss, subject to an arrangement that the shares will be transferred back to their original owners after the end of the loss year. The anti-avoidance provision will also apply where it is the shares of the parent company of the prospective loss company that are acquired subject to a buy back arrangement.

Adjustment Of Loss Offset Deductions - Subsection (8)

The loss company may elect by notice in writing given to the Commissioner, within six months after the date on which the Commissioner gave the loss company notice of the loss reduction, to allocate the loss reduction to the original profit companies in such manner as the loss company, in its discretion, decides.

Where a profit company is no longer a member of the same group of companies as the loss company (whether by sale or liquidation), the loss company cannot elect to allocate amounts of the loss reduction in excess of the amount of loss reduction if it was prorated among the original profit companies.

Where the election to allocate the reduced losses is not made, the loss reduction will be pro-rated.

Treatment Of Groups Prior To 1992-93 Income Year - Subsection (9)

This provision is relevant to the interpretation of section 191A(2)(c)(iii) and (iv) which require a profit company and a loss company to be in the same group of companies in the income year the loss was incurred. Subsection (9) provides that, for pre 1992-93 income years, the end of income year test for determining group of company status, which was the group of companies test under the former section 191, will continue to apply.

This provision is necessary as the group of companies test under new section 191, which requires commonality to be maintained at all times during an income year, only applies in respect of a full income year from the 1992-93 income year.

Loss Offset Adjustment For Debt Remission - Subsection (10)

Subsection (10) is similar to the debt remission provision in the carry forward of loss provisions.

It effectively imports section 188(6) into section 191A to allow the adjustment of loss offset deductions allowed under section 191A(2) where any debt comprised in a loss giving rise to an offset deduction is subsequently remitted or cancelled.

Where two or more profit companies have been allowed a deduction in respect of a loss company's loss, and that loss is reduced under section 188(6), the adjustment of the loss offset deductions will be determined in accordance with section 191A(8). This is necessary because a particular debt (which is subsequently remitted or cancelled) is subsumed in a loss company's loss in a particular income year. Where a loss company's loss is offset against the assessable income of two or more profit companies, it is not possible to trace the part of the loss which arose from a particular debt which is subsequently remitted or cancelled.

Non-Standard Accounting Year - Subsection (12)

Every reference in section 191A to a year of offset, a preceding loss year or an income year is deemed to be a reference to the accounting year corresponding with that income year where a taxpayer has a non-standard accounting year.

Part Year Grouping in 1991-92 Income Year - Section 191B

Section 26 inserts a new section 191B in the Income Tax Act relating to the current part year grouping of losses in the 1991-92 income year.

Subsection (3A) of former section 191 (inserted by the Income Tax Amendment Act (No 5) 1991) required a group of companies to maintain commonality of ownership at all times from 30 July 1991 to the end of the loss company's 1991/92 income year in order for it to be able to offset losses incurred in the 1991-92 income year. The provision had the unintended effect of preventing companies acquired or formed after 30 July 1991 from grouping their post-acquisition or post-formation 1991-92 profits or losses.

Section 191B will allow companies acquired or formed after 30 July 1991 to offset their post-acquisition or post-formation 1991-92 profits or losses against the profits or losses of other members of the group they entered as a result of their acquisition or formation.

A loss company utilising this provision is required to prepare and furnish to the Commissioner adequate accounts that relate to the part year of loss and detail the amount of loss reasonably and fairly attributable to that part year.

The former section 191(7A) will continue to apply to grouping of losses incurred in the 1991-92 income year. Therefore, part year grouping is allowed under new section 191B if the loss company maintains shareholder continuity of 40 percent under the old rules as modified from Budget night until the end of its 1992-93 income year.

The continued application of former section 191(7A) in respect of the 1991-92 income year means that it is only the purchaser (or subscriber) of a loss company that can take advantage of new section 191B. A vendor of a loss company in the 1991-92 income year would have automatically fallen foul of former section 191(7A).

Deductibility of Interest on Money Borrowed to Acquire Shares in Group Companies - Section 106(1)(h)(ii)

Section 16 amends section 106(1)(h)(ii) of the Income Tax Act, which allows a company to claim an interest deduction on money borrowed to acquire shares in another company in the same group as the borrowing company.

Under the new section 191, two or more companies must be members of a group at all times during the income year to qualify as a group of companies for that income year.

Section 16 effectively preserves the group of companies definition under former section 191 in relation to section 106(1)(h)(ii). A company will therefore continue to be able to claim an interest deduction on money borrowed to acquire shares in another company if both companies are members of the same group of companies at the end of an income year.

State-Owned Enterprises - Repeal of Section 197B

Section 28 repeals section 197B of the Income Tax Act, which effectively prevented one state-owned enterprise grouping with another. Section 197B is no longer necessary in light of the new special corporate entity (which state-owned enterprises are a category of) provisions contained in new sections 8A to 8F, relating to the measurement of voting and market value interests.

The definition of "state-owned enterprises" as being persons specified in the Fourteenth Schedule to the Income Tax Act, contained in former section 197B, has been transferred by *section 2(8)* to section 2 of the Income Tax Act.

Attributed Foreign Losses and Tax Credits - Consequential Amendments

Sections 31, 32 and 33 make consequential changes to the provisions in Part IVA of the Act relating to attributed foreign losses and foreign tax credits.

Part 3C - Carry Forward of Imputation Credits - *Section 51*

Section 51 introduces amendments to section 394E on the carry forward of credits in the imputation account.

Identical amendments are made to carry forward of credits in the dividend withholding payments account and branch equivalent tax account.

The changes made by *sections 51, 57 and 60* apply the new provisions contained in sections 8A to 8F, as introduced by *section 7* of this Amendment Act. Sections 8A to 8F provide for the measurement of interests in a company.

The changes :

- reduce the continuity threshold from 75 percent to 66 percent;
- replace the rights to profit test with tests using voting interests or market value interests;

- replace the exemptions provided to listed companies, statutory producer boards and cooperative companies with new concessional tracing rules.

With the exception of the continuity threshold, the credit carry forward provisions are thereby aligned with the loss carry forward rules. The changes reduce compliance costs of taxpayers, especially widely held companies and correct some defects existing under the previous carry forward provisions.

66 Percent Continuity Of Shareholding - Section 394E(1)(g)

Continuity of shareholding of at least 66 percent is measured by aggregating the minimum voting interests and, where a market value circumstance exists, by aggregating the minimum market value interests held by shareholders of a company. Minimum voting interests and minimum market value interests are discussed in Part 2 above in the context of losses.

Where a market value circumstance exists, unless there is 66 percent continuity in shareholding using the voting interest test ***and*** 66 percent continuity using the market value test, there will be a deemed debit to the imputation credit account balance at a specified time.

The specified time is any time credit continuity is breached.

Example 1: Debit Where 66 Percent Continuity Breached

C Co has the following credits arising from tax payments.

7/7/93	$100
7/11/93	$100
7/2/94	$300

From 1/4/93, voting rights attached to shares in C Co is held equally between K and L. On 14/1/94, L's interest is sold to M. The continuity of shareholding has been breached with respect to credits arising before the breach. Debits arising to the imputation account are:

14/1/94	$200

Assuming K and M continue to hold their respective interests, the credit of $300 may be carried forward.

Instruments Relevant to Measurement of Voting Interest and Market Value Interest - Sections 8A to 8F

Generally, only instruments which carry rights to vote as described in section 8C are relevant to the measurement of voting interests. Instruments with nil or insignificant voting rights are generally ignored. For the purposes of credit continuity, however, it is necessary to take into account instruments which are shares as defined in section 2 of the Act and in relation to which dividends are paid which may carry imputation credits.

Fixed rate shares and section 192/195 debentures are shares as defined and may carry imputation credits. These instruments are taken into account to ensure greater accuracy in the determination of shareholders interest in the company for credit continuity purposes.

Only fixed rate shares and sections 192 and 195 debentures issued before the 1991 Budget, that is before 8 pm of 30 July 1991 are ignored in the measurement of voting and market value interest.

Deemed Market Value Circumstance - Section 8B

The issue of certain instruments such as options, fixed rate shares and sections 192/195 debentures are deemed market value circumstances. The definition of the term "market value circumstances" is more fully discussed in Part 2 above.

As regards fixed rate shares, only post-Budget fixed rate shares, if they fall within paragraph (a)(ii) of the definition of market value circumstance give rise to deemed market value circumstances for purposes of the credit account continuity provisions. In addition, issues of post-Budget section 192/195 debentures are deemed market value circumstances.

Tracing Concessions - Section 8E

As discussed in Part 2 above, a person's economic interest indirectly held in a company is calculated by multiplying down through interposed companies. To lower compliance and administrative costs, certain attribution rules have been developed which are effectively tracing concessions for purposes of the loss and credit continuity provisions.

Tracing concessions apply for interests of less than 10 percent, whether held directly or indirectly in a company. In addition tracing concessions are available to companies for which full compliance would be extremely time consuming. Such companies are defined as "limited attribution companies" - the term is defined as meaning listed companies, widely held companies, limited attribution foreign companies, cooperative companies and building societies. Where a limited attribution company holds less than 50 percent directly of the voting or market value interest in a company, the shareholding of the company may be attributed to the company itself. Actual changes in the shareholding of the limited attribution company are ignored.

The tracing concession would not apply where there is an actual breach in the continuity of shareholding (which is not solely due to ordinary trading of shares between holders of less than 10 percent interest in the company) and the directors of the company have actual or constructive knowledge of the breach.

These concessions are more fully discussed in Part 2 above.

The former tracing concessions contained in section 394E(3) to (4) for listed companies, statutory producer boards and its wholly owned subsidiaries and cooperative companies have been repealed.

Date Debit Arises - Section 394E(2)

The time the debit arises is the specified time.

Continuity period - Section 394E(4)(b)

Clarification is provided in section 394C(4)(b) that credit continuity is required from the time the credit arises to the time the debit arises, regardless of whether the continuity period spans several imputation years.

Order of debits - Section 394E(4)(c)

Any amount of debit may be taken into account once only and is deemed to be offset against credits in the same order in which the credits arise.

Credits Arising Before 16 December 1988

New section 394E(4)(d) repeats the old provision which preserves credits arising before 16 December 1988 despite breaches in continuity. This provision is necessary as continuity was not a requirement until 16 December 1988.

Section 394E(4)(e) - Transitional Provisions: Credits Arising Before 1 April 1992

Pre-1 April 1992 credits are subject to the transitional provision in section 394E(4)(e). For carry forward into the period post 1 April 1992, those credits must satisfy the old continuity requirements as if the threshold was 66 percent and not 75 percent, in addition to the new continuity requirements. Those credits in respect of which the old continuity requirements are not complied with will be cancelled by a corresponding debit.

In addition, because unused pre-April 1992 credits are deemed to arise on 1 April 1992, they are also subject to the new rules from that date.

Example 2 (Illustrating transitional provision)

D Co is an imputation credit account company with four shareholders A, B, C and D with 25 percent each of the rights to profits in the company.

The imputation credit account has the following transactions:

	Credit	Debit
1/5/91	$1500	
1/7/91		$500
6/2/92	$500	
Closing balance 31/3/92	$1500	

The following share transfers occurred:

9/9/91	B to E -	25%
7/6/92	C to E -	25%

Applying the old continuity provisions, there is a 50 percent change in shareholding as at 7/6/92. At the specified time, being 7/6/92, there has been a breach of the old continuity provisions.

Applying the new continuity provisions, there is a 25 percent change in shareholding as at 7/6/92 (the pre-1 April 1992 credits being deemed to arise in the company's imputation credit account on 1 April 1992). Continuity under the new provisions has been maintained.

Continuity of both old and new provisions is required. A debit of $1,000 arises.

The $500 credit arising on 6 February 1992 is not lost because shareholder continuity has been maintained for that credit.

Part 4 - Tax Recovery

Introduction

Section 34 replaces the tax recovery provision in section 276 with a better targeted tax recovery provision. Tax recovery using section 276 may apply to:

- asset stripping arrangements;
- directors of the company;
- controlling shareholders of the company;
- other shareholders of the company who have derived a benefit from the arrangement.

Background

The former provision enabled the Commissioner to recover tax from a successor of a company owing tax. A number of deficiencies were identified, its scope was too broad and its wording enabled companies to strip assets out so they were unable to fully meet their tax liabilities. The new provision addresses those deficiencies. It enables the Commissioner to recover tax from the shareholders and directors of the company responsible for the company's actions which result in its not being able to satisfy its tax liability.

Purpose And Effect of An Arrangement - subsection (2)

The tax recovery provision will apply where:

- the arrangement entered into has the effect of leaving the company unable to satisfy its tax liability; and
- it can be reasonably concluded that a purpose of the arrangement was to have this effect.

It is not necessary that the purpose underlying the arrangement be a dominant purpose.

Excluded Arrangements - Subsection (3)

The tax recovery provision will not apply to:

- arrangements, both formal and informal, to which the Commissioner is a party;
- arrangements to the extent that such arrangements have been previously assessed and the tax duly paid;
- any arrangement entered into at a time the company is under statutory management.

> **Example 1** (To illustrate a type of excluded arrangement)
>
> Broke Co sells its only asset, making a profit of $1000. The tax liability of $330 is not paid. Instead the company distributes the profits by way of dividend to its four shareholders. Tax totalling $330 on the dividend income is paid by all four shareholders.
>
> The company is unable to pay its tax of $330. However, as the tax liability is equal to the tax paid by the shareholders, section 276 may not apply to this arrangement.

Persons Liable - Directors and Shareholders - Subsections (4) and (5)

Section 276 applies to recover income tax from those persons who had sufficient control of the company to have been party to the company's decision to enter into an arrangement which leaves the company unable to meet its tax liability. The persons targeted are also the ones most likely to derive personal benefit from the arrangement. Directors per se, controlling shareholders as defined and non-controlling shareholders who, by virtue of the benefits derived from the arrangement have been party to the arrangement, may be liable under this provision.

Definition of Director - Subsection (1)

For purposes of section 276 a director is a person occupying the legal office of director. Where a corporate entity does not have directorships, any trustee, manager or other person who acts in the same or similar fashion as a director would be treated as a director of that entity.

Executive and Non-Executive Directors - Subsections (4) and (5B)

Directorships can be broadly categorised into executive directorships and non-executive directorships. With certain exceptions, both executive and non-executive directors may be jointly and severally liable for outstanding company tax under section 276.

A director may avoid this liability where he or she:

- casts a dissenting vote against that transaction or arrangement and gives notice of his or her dissent to the Commissioner at the first reasonable opportunity after becoming aware of the arrangement, provided that the director concerned does not derive any benefit from the arrangement; or
- is a non-executive director and it is proved that at all material times he or she did not benefit from the arrangement and further did not have actual knowledge of the arrangement.

> **Example 2** (To illustrate exclusions of liability for certain directors)
>
> (Assume for purposes of this example and examples 3 and 4 that the shareholders in example 1 did not pay the tax on the dividend income received)
>
> Crooks and Brooks are executive directors of Broke Co. Crooks voted in favour of selling the company's only asset. Brooks was uncertain about the application of section 276 and dissented. Brooks gives notice of his dissent to Inland Revenue the next day. Another director, Savvy is a non-executive director. Savvy voted in favour of the arrangement by proxy, without having any knowledge of the matters discussed. He finds out about the arrangement over drinks the day after the transaction is entered into. Savvy does not benefit from the transaction.
>
> Of the three directors, the Commissioner may apply section 276 to recover Broke Co's unpaid tax from Crooks. Brooks is not liable because he dissented to the arrangement, notice of which was given to the Commissioner at the first opportunity and further because he did not derive any benefit from it. Savvy is not liable because he is a non-executive director who, at all material times, did not derive any benefit from the arrangement and did not have actual knowledge of the arrangement.

Subsection (1) - Definition of Controlling Shareholders

A controlling shareholder is defined as any person with more than 50 percent voting interest or market value interest in a company at the time the arrangement is entered into. To determine if a person is a controlling shareholder that person's voting interest or market value interest is aggregated with the voting interest or market value interest of associated persons. The term "associated persons" is defined in section 8 of the Act.

Example 3 (To illustrate the definition of "controlling shareholder")

Broke Co's shareholders are:

Mr Mangle	60 percent voting interest
Mrs Mangle	10 percent voting interest
Susie	10 percent voting interest
John	20 percent voting interest

Susie is Mrs Mangle's sister. Applying the associated persons test in section 8, Mr and Mrs Mangle and Susie are associated persons. Each of them are deemed to have controlling interests in Broke Co with 80% voting interest or market value interest each (as the case may be) in the company.

Extent of Controlling Shareholders' Liability - Subsection (5)

Controlling shareholders may be liable for the company's outstanding tax to the limit of the greater of:

- the market value of the controlling shareholder's direct and indirect shareholding in the company at the time the arrangement is entered into (excluding voting interests or market value interests of associated persons); and
- the value of any benefit derived by the controlling shareholder.

Example 4 (To illustrate the extent of a controlling shareholder's liability)

Mr Mangle, Mrs Mangle and Susie received $300 each in dividends from profits arising from the arrangement to sell the asset. John received $100 of dividends. At the time the arrangement was entered into, the market value of the company was $500.

The amount of tax to be recovered is $330.

As the voting interests were held 60 percent (Mr Mangle), 10 percent (Mrs Mangle) and 10 percent (Susie), each may be liable to the extent as follows:

Mr Mangle

The greater of:

60 / 100 x $500 = $300 (market value of interest), or $300 (benefit received)

Limit $300

Mrs Mangle

The greater of:

10 / 100 x $500 = $50 (market value of interest) or $300 (benefit received)

Limit $300

Susie

The greater of:

10 / 100 x $500 = $50 (market value of interest)

or $300

Limit $300

Other Shareholders

Other shareholders targeted by the tax recovery provision are shareholders with less than 50 percent voting interest or market value interest in the company, that is, non controlling shareholders.

Example 5 (To illustrate a non controlling shareholder)

In the fact situation of Broke Co as assumed in the above examples, John has less than 50 percent voting interest in Broke Co. John is a non controlling shareholder.

Liability of Non Controlling Shareholders - Subsection (5)

A non controlling shareholder is liable where at the time the arrangement was entered into it could reasonably be concluded having regard to the materiality of the benefit derived by that shareholder, that the shareholder was a party to the arrangement.

Whether or not a benefit received is of sufficient materiality in correlation to the interest held in a company such that it may be reasonably concluded that a person was a party to an arrangement is a question of fact.

Extent Of Non Controlling Shareholder's Liability

Where a non controlling shareholder is liable under section 276, the extent of that liability is determined in the same way that it is determined for controlling shareholders.

Example 6 (To illustrate extent of non controlling shareholder's liability)

(Assume facts from examples 3,4 and 5)

John received 1 / 10th of the total benefits distributed from the arrangement ($100 out of a total distribution of $1000).

John's market value interest is 20 / 100 x $500 = $100

John has received no greater benefit than his proportion of the shareholding in Broke Co. In the absence of other facts implicating John in the arrangement, it is not reasonable to conclude that John was a party to the arrangement. John is not liable for the company's unpaid tax.

Liability For Additional Tax/Late Payment Penalties - Subsection (5)

Where the company is charged penalties or additional taxes for late payment, the Commissioner may recover that amount outstanding as part of the tax liability outstanding.

Allocation of Liability Among Shareholders For Additional Tax/ Penalties

Liability among shareholders whether controlling shareholders or non controlling shareholders or both is apportioned in the same proportion as those persons are liable for the principal tax amounts.

Example 7 (To illustrate the allocation of liability for additional tax / penalties)

From the above examples, the extent of the shareholder's liability has been determined as:

Mr Mangle - $300 }
Mrs Mangle - $300 } 90% of $330 tax outstanding
Susie - $300 }

Accordingly each of the three shareholders above may be made liable for up to 90 percent of the total amount of additional tax / penalties.

Assuming penalties total $100, each may be liable for up to $90 of penalties.

Allocation Of Liability Among Directors And Shareholders

Section 276 does not prescribe how the liability will be allocated between the directors and shareholders. The Commissioner will be able to chose the persons who will be made liable under section 276. The persons who are required to pay the tax will be notified via a notice of recovery. Once the debt has been satisfied in full, the Commissioner will notify them of their release from liability.

Liability As Agent Of Company - Subsections (4) (5) and (5A)

Where section 276 is applicable, the tax liability of a company is recoverable from the directors and shareholders of the company as agents of the company.

Section 268(3) of the Act on the liability of agents and principals states that agents shall be jointly and severally liable where there are several agents. This may conflict with the section 276 provision of recovery from shareholders to the maximum of the shareholder's interest in the company or benefit derived from the arrangement. To avoid such conflict section 276(5) overrides section 268(3) of the Act.

Rights Of Objection To Assessment - Subsections (6) and (7)

The Commissioner will raise an assessment on the corporate tax-payer who may exercise rights of objection to assessments disputed according to prescribed procedure under the Act. Where the company assessed has been wound up, objection rights will be granted to the directors and shareholders from whom recovery is sought.

Statutory Limitation On Amended Assessments - Subsection (8)

Section 25 of the Act imposes a four year limitation to the issue of amended assessments. Section 276 will not apply where the time limitation has expired in relation to amended assessments. Section 276 will also not apply to the issue of original assessments where the corporate tax-payer has been wound up, provided its final return has been furnished to Inland Revenue by the due date for filing prescribed in section 17 of the Act.

Application Date

The new recovery provision in section 276 may apply to any arrangement entered into after the 30th of July 1991 in respect of any income year assessment.

Arrangements entered into after 30th July 1991 may be subject to the old and new tax recovery provisions, at the option of the Commissioner.

Part 5 - Qualifying Company Regime

Introduction

An elective regime for the taxation of closely-held companies as outlined in *section 48* (which introduces a new Part XIIAA of the principal Act) will take effect from the 1992-93 income year.

The main objective of the qualifying company regime is to treat, as far as possible, the shareholders and the closely-held company as one entity. To this end they are treated in a manner that is closer to that of a partnership. This new status will offer shareholders tax free access to capital gains derived by closely-held companies without having to wind the company up.

In addition, a second type of qualifying company has been created, a loss attributing qualifying company. This type of company, as the name suggests, can attribute losses directly to its shareholders.

The legislation is developed so that taxpayers must first determine whether they fulfil the criteria to be a qualifying company. Both the shareholders and directors of the company must elect by way of a notice that the company should be a qualifying company. In addition, certain rules are developed for revocation and cessation of such status.

The treatment of the taxation of shareholders and the determination of exempt and imputed dividends from a qualifying company is outlined. In addition, for a company to become qualifying company, qualifying company election tax must be determined and paid.

Then the criteria and mechanisms for becoming a loss attributing qualifying company and the treatment of those losses are discussed. Finally, the transitional measures are outlined, together with the special concessions that are available providing the election to be a qualifying company is made before 31 March 1993.

Background

The Valabh Consultative Committee, in its interim and final reports on the Taxation of Distributions from Companies (released in November 1990 and Budget night 1991 respectively), made recommendations on the taxation of closely-held companies. This has formed the foundation for the qualifying company regime.

Interpretation - Section 393A

Summary

- the distinction made between cash and non cash dividends is maintained for distributions from qualifying companies;
- a new term of effective interest is introduced.

Dividends

The definition of dividends that applies to Part XIIAA of the Act is that which applies generally in the Act. However, in relation to dividends paid by qualifying companies, the focus will be on cash-dividends and taxable bonus issues, as outlined below.

Effective interest

A new term, "effective interest", is introduced. It is necessary to determine a shareholder's effective interest in a company in order to:

- determine the appropriate proportion of a qualifying company's tax liability a shareholder assumes;
- determine when certain shareholder elections can be made by majority shareholders; and
- serve as the basis for attributing losses of loss attributing qualifying companies.

The definition of an effective interest picks up on the ownership rules under sections 8A to 8E. The shareholder's voting interest will primarily determine the effective interest in the company. However, where a market value circumstance exists, the average of market value and voting interest must be taken. An effective interest may be determined at any point in time as being that person's voting interest (or average of voting and market value interest where appropriate) in the qualifying company at that time. Determination of a shareholder's effective interest on this basis is relevant in applying section 393D.

A shareholder's effective interest may also be determined in respect of an income year. For this purpose, where a shareholder's voting or market value interest in a company varies during the year a weighted average of that voting or market value interest is taken.

Example 1 - determining effective interest

A shareholder has a voting interest for 5 months of the year of 60%. The shareholder reduces his / her shareholding to 20 % for the remaining 7 months. The person's effective interest for the year is:

$$\frac{(.60 \times 5)}{12} + \frac{(.20 \times 7)}{12}$$

$$= .25 + .12$$

$$= .37 \text{ or } 37\,\%$$

The shareholder will therefore be liable for 37% of the total tax assessed for that income year if the company defaults, or be entitled to 37% of the company's losses if it is a loss attributing qualifying company.

The use of a weighted average to determine a shareholder's interest where the interest varies should also accommodate part year entry and exit of the shareholder from the regime (Refer section 393H(2) for ability to modify this rule)

Any reference to an income year also includes a reference to a non-standard income year.

Criteria for Entry into the Regime - Section 393B

Summary

- certain criteria must be met for companies to qualify for the regime;
- special look through rules are developed to ensure that the numbers test is correctly measured;
- exceptions to the look through rules in cases of death and divorce of shareholders are catered for, to ensure the numbers test is not breached in those situations.

Criteria

Companies will be eligible to enter the qualifying company regime so long as the following criteria are met:

- at any time during the income year the company is not a foreign company;
- the company has at all times five or fewer shareholders or, alternatively, it is at all times a body corporate through which shareholders obtain use of residential property;
- each shareholder in the company is at all times a natural person, or trustee of a trust where all dividend income from a qualifying company is distributed to beneficiaries, or another qualifying company (subject to look through provisions);
- the company receives during the year no more than $10,000 of foreign non-dividend income. Total assessable income from financial arrangements involving foreign transactions is ignored for the purposes of computing whether the $10,000 is breached to the extent that such revenue is less than 10% of the company's total assessable revenue;
- the shareholders and directors have at all times elected that the company be a qualifying company and these elections have not been revoked. However, majority shareholders can elect on behalf of minority shareholders as long as the majority shareholders assume the minority's liability;
- The shareholders must also assume personal responsibility for the income tax payable by the company. In general, of course, the company will meet its tax liabilities;
- the company has not ceased to be a qualifying company as a result of ceasing to be a loss attributing qualifying company.

In addition, the company cannot be a unit trust (as defined in section 211(1)).

In certain circumstances where a person fails any one of these criteria, the Commissioner can determine the date on which the company ceases to be a qualifying company (refer section 393G).

Determination of the numbers test

Shareholders related by blood or marriage within one degree (e.g. parent / child, husband / wife) are deemed to be one shareholder. It is important to note that brothers and / or sisters are not related to within one degree. The death or dissolution of marriage of shareholders will not break the one degree test, provided that the relevant persons were, prior to the event, treated as a single shareholder.

Where the shareholder is a company, provision has been made to look through the shareholder company to their ultimate shareholders under section 393B(3)(a).

Where shares in a company are held by a trustee, the shareholders in respect of that trustee's interest are the persons who have derived beneficiary income or those persons (other than the trustee) who made a shareholder election under section 393D(2), whichever group is larger in number. In such circumstances, the trustee is not treated as a shareholder for the purposes of the shareholder count test.

Shares held by a nominee are also deemed to be held by the person and not the nominee.

A general anti-avoidance provision is included, disallowing entry into the regime if the Commissioner is of the opinion that the shares have been subject to an arrangement for the purposes of making them a qualifying company so as to defeat the intention and purpose of the regime

Example 2: Shareholder Count Test

Shareholders

Jack	-	Father
Jane	-	Wife (step mother)
Paul	-	Son
Pauline	-	Paul's wife
Company A	-	Qualifying company with Jack, Jane, Paul and Mary (Jack's sister), and Joe (unrelated).
Trust	-	Beneficiaries, Sandra (Jack's first wife and mother of children), Paul (20 years old), Susan (12 years old).

For the qualifying company regime, there are only four shareholders.

Jack - Jane, Paul, Susan (1 degree from Jack).

Joe (unrelated shareholder)

Pauline (2 degrees from Jack)

Mary (2 degrees from Jack)

Sandra (divorced wife, but divorced before company was a qualifying company)

It is important to note that the shareholder numbers test does not impact on the determination of each individual shareholder's effective interest calculation.

Elections

Summary

- To qualify under the regime both shareholders and directors must file notices of elections;
- shareholders will also be personally liable for any income tax not met by the company;
- all shareholders must file election notices; although a majority election removes the requirement for minority shareholders to file election notices;
- elections will generally take effect from the beginning of the next income year following receipt of the notice;
- certain events will trigger a revocation of a notice;
- periods of grace under each of the circumstances are allowed for subsequent elections to be made, thus ensuring the continuance of qualifying status;
- the revocation of an election will take effect from the beginning of the year the event took place;
- the loss of qualifying status, either through revocation or failure to fulfil the criteria, is subject to the Commissioner's discretion to extend the revocation date in certain circumstances.

Elections

In general, elections take effect on the first day of the income year following the election, although, companies may nominate future income years. Therefore, elections must be made within the income year which precedes the year in which the company wishes to qualify.

However, a newly-formed company can nominate to be a qualifying company from the first day of the company's first income year. This is providing such an election is made no later than the time for furnishing the company's first income tax return.

Directors' elections - Section 393C

All directors must elect by notice in writing to the Commissioner that the company should be a qualifying company.

A directors' election may be revoked only by the board of directors notifying the Commissioner. This revocation of election will result in the company no longer meeting the criteria for qualifying company status from the beginning of the income year in which the notice is received by the Commissioner or the later income year specified in the notice.

Shareholder elections - Section 393D

All shareholders who are *sui juris* (of legal capacity) must elect by notice in writing to the Commissioner (via a "shareholder election") that the company should become a qualifying company. They will also be liable for the company's income tax assessed, based on their respective effective interests in the company.

If the shareholder is a trustee, then the trustee and one or more natural person beneficiaries who are *sui juris* must elect. If there are no *sui juris* beneficiaries, then a natural person (who could be the trustee) must assume liability for the trust's effective interest and complete a shareholder election. The liability for tax will be to the extent of the net assets of the trust in the case of the trustee, and jointly and severally for the beneficiary or person assuming the beneficiary's liability (which could be the trustee).

In determining who has to make the election it is important to note that the look through rules only apply for the count test and not for the election requirements. Where a chain of qualifying companies exists, only the shareholder qualifying company must complete a shareholder election and assume liability. Similarly, in the case of a nominee interest it is the nominee who elects.

Majority shareholder elections

One or more *sui juris* shareholders whose interest exceed fifty percent may elect that the company should become a qualifying company, if in addition to their own liability, they assume that of the minority shareholders.

Revocation of shareholder elections - Section 393E

A shareholder can revoke an election by notice in writing to the Commissioner. The revocation will take effect from the beginning of the income year in which the notice is received by the Commissioner or any future income year specified in the notice. Any revocation will result in the company not being a qualifying company from the beginning of the relevant income year.

The following events will result in previous elections being revoked:

1. notice of revocation by shareholder(s);
2. death of a shareholder;
3. sale of the shares to a person who is not currently a shareholder in the qualifying company;
4. a beneficiary of a trust becoming *sui juris* in certain circumstances;
5. a minority shareholder becoming a majority shareholder and vice versa;
6. any one person of two or more persons who have jointly made an election revoking that election.

Periods of grace for each of the events - Section 393F

However, a company will not cease to be a qualifying company if any of the following occurs:

- the company would have been a qualifying company but for the death of the person and the company meets all of the criteria for being a qualifying company within 12 months -for example, by a new shareholder as the executor making a shareholder election within that twelve month period;

- any other person eligible to make a shareholder election under section 393D makes or is deemed to have made an election within 63 days after the date of a shareholder revocation;
- the acquiring shareholder makes an election within 63 days of the sale or disposal of the shares by the shareholder.
- the *sui juris* beneficiary (where no *sui juris* beneficiary was present before) or a subsequent *sui juris* beneficiary (where an existing *sui juris* beneficiary does not want to accept liability for the new *sui juris* beneficiary) or a majority shareholder makes a shareholder election with 63 days of the first beneficiary becoming *sui juris*;
- the minority shareholder makes an election within 63 days of becoming a majority shareholder, or the new majority shareholder makes an election in respect of the minority shareholding within 63 days;
- a jointly made election is revoked due to any of the events listed above, and a new election is made within the relevant period of grace;
- in the case of an issue or allotment of any shares to a person who is not currently a shareholder, the new shareholder makes a shareholder election within 63 days.

The Commissioner may extend the periods of grace upon application by either the company or the person making the shareholder election.

In addition, where an election is revoked and a subsequent election is taken up in its place, the latter election is deemed to take effect at the beginning of the income year in which the revocation event or notice took place. The voting (or market value) interests of the new shareholder are taken into account in determining the new shareholder's effective interest from the time of first becoming a shareholder in that income year (by virtue of section 394A(2)).

Date on which a non-complying company ceases to be a qualifying company - Section 393G

Where a qualifying company ceases to fulfil the criteria to be such, the company will generally cease to a qualifying company from the beginning of the income year in which the event occurred.

However, if at the time the event occurred the company could not have been reasonably expected to know that it did not qualify, it can apply to the Commissioner for a later time of revocation. The Commissioner may specify a later date on which the company shall cease to be treated as a qualifying company.

Events which might trigger the application of this section could include, for example:

- a company had an overseas account which it was not aware of for the past three years which has resulted in the company tripping the threshold level for foreign income. Generally, the company would lose its status from the beginning of the three year period; or
- a shareholder gifted all of its shares to another person who was overseas for two years, out of contact and unaware that she or he was required to make an election. The shareholder subsequently chooses to decline to make an election. Normally, the time of revocation would be from the beginning of the year in which the shares were gifted, but clearly the Commissioner would exercise his discretion in this instance.

Liability of electing shareholder for tax of the company - Section 393H

This section determines that the shareholder who has elected for the company to be a qualifying company will be liable for any percentage of the company's income tax liabilities arising under Part IV of the Income Tax Act 1976 as if the shareholder was an agent of the company. Moreover, neither the company nor the shareholder/agent will be precluded from an assessment.

In general, a shareholder's part year liability will be satisfied through the weighted average formula. However, the Commissioner can reduce this liability where shares are sold or disposed of and adequate accounts are kept which support a lower amount, and the Commissioner is satisfied, based on the circumstances, that the liable portion computed using the weighted average calculation of effective interest would be inappropriate.

Taxation of Shareholders - Section 393I

Summary

- dividends that shareholders receive will either be exempt, fully imputed or returns of 10 year bonus issues;
- the costs of providing a non cash benefit to a shareholder will be denied to the company as these benefits are exempt dividends in the hands of such shareholders.

Dividends

A dividend to a resident shareholder from a qualifying company will either be fully imputed or exempt. The distinction is determined under section 393M of the Act. This generally means that where the company pays no tax on a profit such as capital profits, they will flow through to the shareholder tax free.

Shareholders of some qualifying companies will be able to elect to also have access to the company's losses. This type of loss attribution qualifying company is covered in more detail under section 393N.

Where a non-employee shareholder receives in-kind benefits, the cost of providing such benefits (e.g. interest) will be non-deductible to the qualifying company. In addition, the benefit (non-cash dividend) will be exempt to the shareholder by virtue of section 393M. Where a shareholder has borrowed money to acquire shares in a qualifying company, the interest cost attributable to the loan will only be deductible in any income year to the extent that it exceeds the value of non-cash dividends that the shareholder receives in that year.

Where a dividend arises through the making available of any property to a shareholder, this dividend will be deemed to be paid and derived at the end of each quarter of the qualifying company's income year. Note that the concession in section 4(10) for the time of payment for s4(1)(e0 dividends does not apply.

Taxation of Qualifying Companies - Section 393J

Summary

- qualifying companies will be taxed on all dividends they receive from other companies;
- losses are restricted in certain circumstances so that they can only be grouped with those of other qualifying companies;
- No RWT will be deducted on dividends paid to a qualifying company prior to 1 April 1992.

Taxation of qualifying companies

Qualifying companies will be taxed on all dividends they receive. For the 1992-93 income year this means that qualifying companies with early balance dates will be taxed on dividends prior to 1 April, when the general inter-corporate dividend exemption is removed (unless those dividends derived by the qualifying company were from other companies within a 100% commonly owned group). It also means that the exemption until 1 April 1994 for dividends paid on redeemable preference shares issued prior to the Budget will not apply to qualifying companies receiving such dividends.

Losses are restricted for grouping purposes, in that a qualifying company in profit can only offset against another qualifying company in the same group in loss. However, this does not restrict the offsetting of qualifying company losses against non-qualifying company profits.

No resident withholding tax will be deducted on dividends paid to a qualifying company prior to 1 April 1992.

Imputation credits attached to dividends received by the company will be credited to its imputation credit account and will be available to offset its tax liabilities. Foreign dividend withholding payment credits attached to dividends received by a qualifying company may be credited to its dividend withholding payment account, where the company maintains such an account. Foreign dividends are exempt under section 63 of the Act, and subject to the dividend withholding payment regime

Qualifying Company Election Tax (QCET) - Section 393K

Summary

- companies must determine the extent of QCET upon entry into the regime;
- the determination of QCET is based on an artificial winding up of the company and is payable at the company tax rate (33%) (see Page 57 for transitional rules);
- any losses available to be carried forward upon entry into the regime are automatically lost;
- payment of QCET must be made by the company's terminal tax date for the income year the election applies to (generally, 7 February of the following year).

Determination of QCET

Dividends paid by a qualifying company to its shareholders will either have maximum imputation credits and/or dividend withholding payment credits , attached or be exempt from tax. It is therefore necessary to provide an entry tax on the company's reserves at the time of entry into the qualifying company regime, as once the company is a qualifying company those reserves will subsequently be tax free to the extent that credits are not attached . The tax on such reserves is referred to as the "qualifying company election tax" or QCET.

The company will pay this tax on the amount calculated in accordance with the following formula (broadly, this is the amount which would have been taxable if the company were to wind up):

$$(a - b - \frac{c}{d}) \times d$$

where a is the amount available to be a dividend if distributed to shareholders under a deemed winding up excluding ten year bonus issues that are still "serving time";

b is the assessable income (or loss) that would have arisen from the disposal of the company's assets and liabilities (i.e. such unrealised amounts are not subject to QCET but are carried across into the qualifying company regime);

c is the aggregated balance of the company's ICA and DWP account prior to becoming a qualifying company (subject to an anti-avoidance provision);

d is the resident company income tax rate expressed as a decimal.

In addition, on entry into the regime all losses carried forward are not available to be used by the qualifying company. This includes foreign losses and foreign investment fund losses.

With respect to the ten year bonus issues "serving time" where they flow through to the shareholder within the ten year period, such a dividend will be fully taxable and not exempt.

Example 3: Determination of QCET

A company's balance sheet (QC Co) on the last day of the 1992/93 income year is as follows.

Assets

Current Assets			
Bank		10,000	
Trading Stock		30,000	
Debtors		5,000	45,000
Fixed Assets			
Land		135,000	
Building	200,000		
Less accumulated depreciation	35,000	165,000	
Fixture and Fittings	80,000		
Less accumulated depreciation	45,000	35,000	
Shares		10,000	
Intangible Assets			
Goodwill		30,000	375,000
			420,000

Liabilities

Creditors	30,000	
Mortgage	150,000	180,000

Shareholders' Funds

Capital	175,000	
Revenue Reserve	65,000	240,000
		420,000

Other Information:

Shares in this case are deemed to be taxable under s65(2)(e). Originally purchased for $9,000.

Building has a market value of $220,000.

Fixtures and fittings have a market value of $80,000

Imputation credits =	15,500 CR
Foreign dividend withholding credits =	4,500 CR
Losses carried forward =	(100,000)

Capital includes $30,000 bonus issue shares arising from the capitalisation of revenue reserves on 1 April 1990 (non-taxable bonus issue shares)

QCET

a = 175,000 (Note 1)

b = 80,000 (dep. recovered: Note 2) + 1,000 (sale of shares)
= 81,000

c = 20,000

d = .33

$$QCET = (a - b - \frac{c}{d}) \times d$$

$$= (175,000 - 81,000 - \frac{20,000)}{.33} \times .33$$

QCET = 11,020

In addition, the company loses all of its losses carried forward upon entry into the regime.

Note 1:

Assets upon realisation =		520,000
less liabilities =		180,000
		340,000
less capital	175,000	
bonus issue	30,000	145,000
Capital gain on building		20,000
		175,000

Note 2:

Buildings		
Market value	=	220,000
Book value	=	165,000
Gain	=	55,000
Accum. depreciation	=	35,000

Fixture: Fittings		
Market value	=	80,000
Book value	=	35,000
Gain	=	45,000
Accum. depreciation	=	45,000

Therefore, depreciation recovered is only $80,000.

It is argued that in simple cases an alternative way of calculating QCETcan be determined as follows:

$$a - \frac{b}{c} = QCET$$

Where a is revenue reserves plus the amount that would be assessable income to the shareholder upon liquidation of the company, less the revaluation of "revenue" type assets

b is the aggregate balance of the company's ICA and DWP accounts

c is .33

Therefore, in the above example:

a = 65,000 + 30,000 - 1,000
= 94,000

b = 20,000

c = .33

$$QCET = 94,000 - \frac{20,000}{.33}$$

= 11,020

Payment of QCET - Section 393L

The payment of this QCET must be made by the company's due date for paying income tax as determined under section 388(2).

The Commissioner will also require at the date of payment a form setting out relevant details of the company.

Additional tax will be levied if the company fails to pay the tax within the stated time period. In addition, the Commissioner can make a default or amended assessment and the company will have the usual objection procedures available to it. The QCET and any additional tax will be treated like income tax and as such is not deductible to the company. This also means that QCET may be subject to the provisional tax use-of-money interest provisions.

Dividends from a Qualifying Company - Section 393M

Summary

- this section only applies to dividends paid to resident shareholders;
- imputation and dividend withholding payment credits are grossed up to determine the amount of dividends that are imputed. A return of a 10 year bonus issue will still be assessable to the shareholder. Dividends not imputed or a return of a 10 year bonus issue are exempt from income tax;
- No FBT is levied on non-cash dividends derived by shareholders of qualifying companies prior to 1 April 1992;
- companies can only attach credits to dividends that are cash dividends or taxable bonus issues;
- the 66% shareholder continuity requirement to carry forward imputation credits does not apply to qualifying companies.

Determination of exempt and imputed dividends

This section determines the amount of dividends fully imputed and the amount exempt to the shareholder. Where a dividend paid by the company to a resident shareholder exceeds the amount of dividend calculated under the formula, that excess is exempt income in the hands of the shareholder. As this section only applies to resident shareholders, all dividends paid to non-resident shareholders of qualifying companies will be assessable and liable to non-resident withholding tax.

The formula grosses up the imputation and dividend withholding payment credits by the company tax rate and treats the balance over the dividend as exempt. The formula is:

$$\frac{a + b}{c}$$

Where: a is the amount of imputation credits attached to the dividends;

b is the amount of dividend withholding payment credits attached to the dividends; and

c is the resident company tax rate expressed as a decimal.

Imputation and dividend withholding payment credits may be attached only to cash dividends and taxable bonus issues.

The amount of any credits that may be attached to dividends paid during an imputation year (item a) is calculated at the end of each imputation year and is the lesser of:

- the maximum imputation credits able to be attached under the imputation regime (section 394G(1)); and
- the amount calculated using the following formula:

$$\frac{a \times b}{c}$$

Where a is the balance in the company's ICA on the last day of the imputation year in which the dividend is paid;

b is the amount of the dividend excluding imputation credits;

c is the aggregate of all dividends paid excluding imputation credits

A similar exercise is required for dividend withholding payment credits.

Example 4: Determination of exempt and imputed dividends

A company has distributed $25,000 cash during the 1992/93 imputation year, in two instalments of $10,000 and $15,000. Its ICA account has a credit balance of $4,500 as at 31 March 1993.

The amount of imputation credits that may be attached to the cash dividends is computed as the lesser of :

- Maximum Imputation credits 31/3/93

$$\frac{33}{67} \times 25{,}000 = 12{,}313$$

- Amount calculated using the formula

$$\frac{4{,}500 \times 10{,}000}{25{,}000} \quad 1{,}800$$

$$\frac{4{,}500 \times 15{,}000}{25{,}000} \quad \underline{2{,}700} \quad 4{,}500$$

The lesser amount is therefore $4,500.

The amount assessable to the shareholder therefore is:

$$\frac{\text{Imputation credits}}{.33} \text{ or } \frac{a}{b} \quad \frac{4{,}500}{.33} = 13{,}636.$$

The second step is to determine the proportion of exempt dividends. This can be computed in the following manner:

Total dividend	29,500
less assessable dividend	13,636
Exempt dividend	15,864

Finally, the shareholder's position would be determined as follows:

Assessable dividend	=	13,636
Tax (assuming 33% bracket)	=	4,500
Imputation credits		(4,500)
Balance taxable		nil

The imputation account of the qualifying company is reduced to zero.

Where a qualifying company maintains a dividend withholding payment account, the attaching of dividend withholding payment credits to cash and taxable bonus issue dividends distributed during an imputation year is computed under section 393M(4) in a parallel manner to that of the crediting of ICA credits.

Any non-cash dividends paid to shareholders before 1 April 1992 will not be subject to FBT. Moreover, where a shareholder has a late balance date and a dividend is derived between 31 March and the shareholder's balance date, that dividend is deemed to be derived by the shareholder in the shareholder's next income year.

The shareholder cannot utilise the imputation credits to any of the exempt component of the dividends for the calculation of its individual tax liability.

Where a qualifying company receives a refund which places its ICA into debit, the company is entitled to the refund provided that the overpaid tax was not part of an avoidance arrangement.

The company dividend statement and shareholder dividend statement required under the imputation provisions must be issued to the shareholder and a reconciliation statement filed by 31 May following the imputation year. A qualifying company must inform its shareholders in the shareholder dividend statements of the portions of dividends which are exempt and taxable. There is no ability to refund excess imputation credits, although excess dividend withholding payment credits are refundable in the normal manner.

The continuity requirement (66%) for maintaining an imputation credit account balance does not apply to qualifying companies. Where a company ceases to be a qualifying company there is a debit to the ICA which is equal to the lesser of:

- the balance at that time (after attaching maximum possible imputation credits to the dividends paid during the imputation year and up to that time); and
- the greatest previous balance in the ICA at that date of any prior breach of the 66% continuity rule.

Loss Attributing Qualifying Company (LAQC) - Section 393N

Summary

- a qualifying company must satisfy additional criteria to be a LAQC;
- additional election requirements must be met and certain revocation rules apply along similar lines to the qualifying company status requirements;
- losses generally will be attributable to shareholders in the proportion of their effective interest in the company;
- a LAQC can make a further election to retain foreign losses at the company level;
- the loss of LAQC status automatically ceases the company to be a qualifying company as well.

Criteria

A company can elect to be a loss attributing qualifying company if all the following criteria are met:

- the company is a qualifying company;
- all shares in the company carry the same rights to;
  - exercise voting power concerning -
    - distributions by the company
    - constitution of the company
    - variation in capital
    - appointment of directors;
  - receive profits;
  - receive distribution of net assets;
  - receive distributions of paid up capital;
  - receive distributions of qualifying share premium.
- a notice of election in writing by either a shareholder or a director in the company is furnished to the Commissioner before the beginning of the income year (or the date for filing a return for a newly incorporated company which has not been revoked); and
- no share of the company has been subject to an arrangement to defeat the intent and application of the section.

Revocation of Election to be a Loss Attributing Qualifying Company - Section 393O

The notice of election to be a loss attributing qualifying company (LAQC) can be revoked by any *sui juris* shareholder or director. The company shall cease to be a LAQC from the beginning of that income year in which the notice is received by the Commissioner, or a later year if specified.

Where any director or shareholder dies, sells / disposes of the company's shares, or new shares are issued or allotted, the acquiring person (not already being a shareholder in the LAQC) must furnish a replacement election within the required time; in the case of death this is 12 months, and for the sale or issuing of shares, 63 days.

Losses - Section 393P

Losses (including foreign losses and foreign investment fund losses) will be directly attributable to the shareholder in the proportion of the shareholder's effective interest. The losses will be deductible against the shareholder's other income, but foreign attributed loss and foreign investment fund losses can only be offset against foreign attributed income and foreign investment fund income respectively, as governed by the international regime.

In general, no losses can be carried forward by the company as they are attributed to the shareholder. However, no loss will be attributed where the shareholder suffers no, or substantially no, economic or financial loss. In this case the losses will be lost to the company and the shareholder.

To be able to elect to be a loss attributing company, the company must have been a qualifying company at all times during the income year. The company must also furnish a notice in writing to the Commissioner before the first day of the income year or the date of filing a return for a newly incorporated company. This notice must be executed by each shareholder who is *sui juris* at the date the notice is furnished and no revocation of the loss election is in effect for that year.

This election can be revoked by any *sui juris* shareholder, with effect from the beginning of the next income year. However, where all *sui juris* shareholders revoke the election, the effective date of revocation is the beginning of the income year in which the notice is furnished to the Commissioner.

Attributed Foreign Losses and Foreign Investment Fund Losses - Section 394Q

A company can elect to retain these "foreign" losses at the company level and carry them forward in order to more readily utilize them against foreign attributed income or foreign investment fund income. Where a company prior to becoming a LAQC had carried forward foreign losses or foreign investment fund losses, the losses will continue to be carried forward by the company notwithstanding the revocation of election.

Ceasing to be a LAQC - Section 393R

Once a company ceases to be a LAQC it also ceases to be a qualifying company from the beginning of the next income year. However, the company can reapply to be a qualifying company and pay another QCET.

Transitional Period - Section 393S

Summary

- companies have until 31 March 1993 by which to elect to be qualifying companies and take advantage of the lower QCET rate;
- payment of QCET will typically be due by 7 February 1994;
- QCET in the transitional period is calculated at the concessional rate of 7.5% on its taxable reserves.
- the company will lose 25% of any losses carried forward upon entry into the regime.

Transitional period

Any election (directors, shareholders, loss attributing and foreign loss elections) made under the previous sections before 31 March 1993 for a company to be a qualifying company in the 1992/93 income year, will be deemed to take effect from the first day of the 1992-93 income year, unless the notice of election specifies a later income year of application.

If such an election is made, the company is subject to the lower QCET rate of 7.5%. The payment of the QCET is governed by section 388(2). This will typically be 7 February 1994.

Concessional rate of QCET - Section 393T

As a concessional transitional measure, where a company elects under section 393S to become a qualifying company, a rate of 7.5 % will apply. The amount of QCET payable will be the lesser of the amount calculated under s393K(2) or the amount calculated under the transitional formula.

However, tax at the full company rate is payable on the excess of exempt dividends received over dividends paid during the period from November 1990 until the date of election to the extent those dividends do not carry credits. This is to prevent companies paying exempt dividend income prior to 1 April 1992 to a company which will make the election to become a qualifying company, thereby taking advantage of the concessional QCET rate.

On entry into the regime, a company must also cancel 25% of its losses. This is equivalent to forfeiting a tax benefit of around 7.5% QCET.

QCET under this transitional period is calculated as follows:

$$\text{QCET} = \left(a - b - \frac{c}{d} - e\right) \times .075 + (e \times d)$$

where a, b, c, d have the same meaning as s.393K (see page 52).

$$e = \left(f + g - \frac{g}{d}\right) - \left(h + i - \frac{i}{d}\right)$$

where
- f is all dividends received by the company (excluding imputation and dividend withholding payment credits) exempt during the period from 30 November 1990 until the first day of the company's 1992-93 income year (the relevant period);
- g is all credits attached to dividends in item f;
- h is all dividends (excluding credits) paid by the company in the relevant period;
- i is all credits attached to dividends in item h;

Essentially item "e" is the amount of unimputed exempt dividends received, less unimputed exempt dividends paid by the company during the relevant period.

Example 5: Determination of QCET in the transitional period

Revisiting the earlier example, the company's balance sheet (QC Co) is as follows.

Assets

Current Assets			
Bank		10,000	
Trading Stock		30,000	
Debtors		5,000	45,000
Fixed Assets			
Land		135,000	
Building (including revaluation)	200,000		
Less accumulated depreciation	35,000	165,000	
Fixture and Fittings	80,000		
Less accumulated depreciation	45,000	35,000	
Shares		10,000	
Intangible Assets			
Goodwill		30,000	375,000
			420,000

Liabilities

Creditors	30,000	
Mortgage	150,000	180,000

Shareholders' Funds

Capital	175,000	
Revenue Reserve	65,000	240,000
		420,000

Other Information:

Shares are deemed to be taxable under s65(2)(e). Originally purchased for $9,000.

Building has a market value of $220,000.

Fixtures and fittings have a market value of $80,000

Imputation credits =	15,500 CR
Foreign dividend withholding credits =	4,500 CR
Losses carried forward =	(100,000)
Inter-company dividends received during the relevant period = (Note: $500 foreign dividend withholding credits included)	5,500
Dividends paid to shareholders during the relevant period = (Note: $4,500 imputation credits included)	14,500

Capital includes $30,000 bonus issue shares arising from the capitalisation of revenue reserves on 1 April 1990 (non-taxable bonus issue shares)

QCET

$$QCET = (a - b - \frac{c}{d} - e) \times .075 + (e \times d)$$

Where a, b, c and d have the same meaning as under section 394ZJI

$$e = (f + g - \frac{g}{d}) - (h + i - \frac{i}{d})$$

a	=	175,000 (assets - liabilities)
b	=	80,000 (dep recovered) + 1,000 (sale of shares)
	=	81,000
c	=	20,000
e	=	$(5{,}000 + 500 - \frac{500}{.33}) - (10{,}000 + 4{,}500 - \frac{4{,}500}{.33})$
	=	3,985 + 864
e	=	3,121
d	=	.33
QCET	=	$(a - b - \frac{c}{d} - e) \times .75 + (e \times d)$
	=	$(175{,}000 - 81{,}000 - \frac{20{,}000}{.33} - 3{,}121) \times .075 + (3{,}121 \times .33)$
	=	(30,273 x .075) + 1,030
	=	2,270 + 1,030
QCET	=	3,300

In addition, the company would lose 25% of its losses carried forward.

100,000 x 25% = 25,000 (lost)

Losses available to be carried forward into the qualifying company regime = 75,000

Application

The qualifying company regime effectively comes into force in the 1992/93 income year.

Due Dates Reminder

April

30 GST return and payment for period ended 31 March 1992 due.

May

5 PAYE deductions and IR 66ES for last 15 days of April due - "large" employers only.

7 First instalment of 1993 provisional tax due for taxpayers with January balance dates.

Second instalment of 1992 provisional tax due for taxpayers with September balance dates.

Third instalment of 1992 provisional tax due for taxpayers with May balance dates.

14 RWT on interest deducted during April 1992 due for monthly payers.

14 RWT on dividends deducted during April 1992 due.

Non-Resident Withholding Tax deducted during April 1992 (or approved issuer levy) due.

20 PAYE deductions and IR 66ES for first 15 days of May due - "large" employers only.

PAYE deductions and IR 66ES for April due - "small" employers.

Gaming Machine Duty return and payment for month ended 30 April 1992 due

31 GST return and payment for period ended 30 April 1992 due.

Specified Dividend Reconciliation (IR 17S or IR 17SA) for RWT on dividends due.

Annual reconciliation statement (IR 15S) due for RWT on interest.