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The tax avoidance landscape is changing

Over the last few years the tax avoidance landscape has undergone a dramatic change. This is largely due to the fact that the Courts are now interpreting the tax avoidance provisions of the Income Tax Act differently. The result of this is that there is now even more uncertainty as to what constitutes tax avoidance. Therefore, taxpayers need to carefully consider the tax avoidance provisions whenever undertaking any tax planning exercise.

Over recent times the IRD has had a number of wins in tax avoidance cases. In fact the score is currently heavily in favour of the IRD and Associate Judge Bell summed up this up as follows:

“... the tide is running in favour of the Commissioner of Inland Revenue on tax avoidance litigation.”

The tax avoidance cases the IRD has won range from cases where the transactions were quite clearly tax avoidance arrangements, to cases involving arrangements that taxpayers perhaps previously considered to be “normal business transactions”.

Quite often taxpayers will come up with ideas to reduce their tax liabilities. In light of the changes to the tax avoidance landscape, taxpayers need to bear in mind more than ever, when entering into these transactions, whether they could constitute tax avoidance. The cost to the taxpayer of the arrangement being found to be tax avoidance will likely far outweigh any tax benefits the arrangement provides to the taxpayer.

Tax implications of shareholding changes

Whenever the shareholding in a company is altered there are a number of tax issues that need to be considered. Some of these issues are complex and if overlooked can result in unintended tax liabilities for the company or shareholder. Therefore, if you are considering altering the shareholding in a company you should always consult with us first. A quick phone call to us may save the company or shareholder from any unintended consequences.

Following are some of the tax issues that need to be considered whenever the shareholding in a company is altered.

Imputation

Upon a shareholding change a company will lose the balance of its imputation credit account (ICA) if the continuity shareholding is less than 66%. If a company loses its imputation credits then Resident Withholding Tax (RWT) will have to be deducted from dividends paid by the company in the future. This results in some of the profits of the company being taxed twice.

If a company is a Qualifying Company (QC) and remains in the QC regime after the shareholding change, the company will not lose the balance of its ICA. However, if the company does not remain in the QC regime after the shareholding change the company will lose imputation credits equal to the lesser of the ICA balance on the day before QC status is revoked and the greatest previous balance in the ICA at the date of any prior breach of the 66% continuity rule.

Tax losses

If a company alters its shareholding and it has tax losses available, these losses will no longer be able to be carried forward to future years if there ceases to be a group of persons whose lowest voting interests in the company from the date the losses arose to the date of the shareholding change is at least 49%. The result of this is that the company will have to pay tax on any profits in the future which could have been offset against the tax losses.

This rule does not apply if the company is a Loss Attributing Qualifying Company (LAQC) and remains in the LAQC regime after the shareholding change. However, the LAQC regime has been repealed for income years beginning on or after 1 April 2011.

QC and LAQC status

A company's QC and LAQC status is revoked if new shareholder elections are not filed within 63 days of a shareholding change in the following circumstances:

- shares are disposed of to a person for whom an election does not exist
- a minority shareholders voting interest increases to 50% or more
- a majority shareholders voting interest decreases to less than 50%

The 63 day period is extended to 365 days if the shareholding change is due to the death of a shareholder.

An LAQC can only have one class of share. Therefore, if the shares in a company are reorganised so there is more

than one class of share, this will result in a deemed revocation of LAQC status.

In order to be a QC the company must have 5 or fewer shareholders. There are special rules that apply to determine the number of shareholders in a QC. Therefore, if new shareholders are introduced to a company and this results in the 5 or fewer shareholder test being breached it will result in a deemed revocation of QC status.

Some of the tax implications of falling out of the QC and LAQC regime are:

- tax losses can no longer be attributed to shareholders
- some capital gains can no longer be distributed tax free or cannot be distributed tax free until the company is wound up

Note the LAQC regime has been repealed for income years beginning on or after 1 April 2011.

Shareholder salaries

In order for a company to pay an individual a shareholder salary, without PAYE deducted, at least one share must be held in that individual's name. If that individual does not have any shares in the company they will be required to receive a salary with PAYE deducted. This can cause problems if part of the company's profit was to be allocated to that individual.

Share repurchases

In some instances a share repurchase by a company can result in an amount being treated as a dividend that is taxable in the hands of the shareholder. The rules surrounding share repurchases are very complex. Therefore, if you are considering a share repurchase, we suggest you obtain advice from us first.

Loss offsets / subvention payments

If a company has tax losses available it can transfer, either by loss offset or subvention payment, these losses to another company to utilise. However, in order to transfer these losses there

needs to be a group of persons that hold common voting rights of 66% or more in both companies from the beginning of the year the loss arose to the end of the year of offset. If a shareholding change results in the 66% requirement being breached these losses can no longer be transferred. This may result in the losses in the loss company being trapped in that company and the profit company having to pay tax on its profits.

Close company

There are a number of provisions within the Income Tax Act that require a company to be a close company for those provisions to apply.

The definition of a close company in respect of paying shareholder salaries without PAYE deducted requires the company to have 25 or fewer shareholders. In all other cases a close company is one in which there are 5 or fewer natural persons whose total voting interests in the company are more than 50%.

If the shareholding in a company changes so that the company is no longer a close company it can impact on the following tax issues, amongst others:

- whether a shareholder salary without PAYE deducted can be paid
- whether dividends and interest derived by a shareholder-employee from the company have to be taken into account when calculating Fringe Benefit Tax
- whether a related party capital gain is taxable on liquidation

Associated persons

There are a number of provisions within the Income Tax Act which tax transactions, which would not otherwise be taxable, between associated persons. If the shareholding in a company changes it could make the company associated with certain other parties. The definition of associated persons is now

very wide. Being associated with a certain party can have tax implications especially in regard to the following:

- Land transactions
- Deemed dividends
- FBT

Consolidated Groups

Companies can form a Consolidated Group for income tax or imputation purposes. A consolidated group is one in which a group of persons hold a 100% common voting interest amongst the group of companies and which has elected into the consolidation regime.

If shareholding changes occur a company could fall out of the consolidated group.

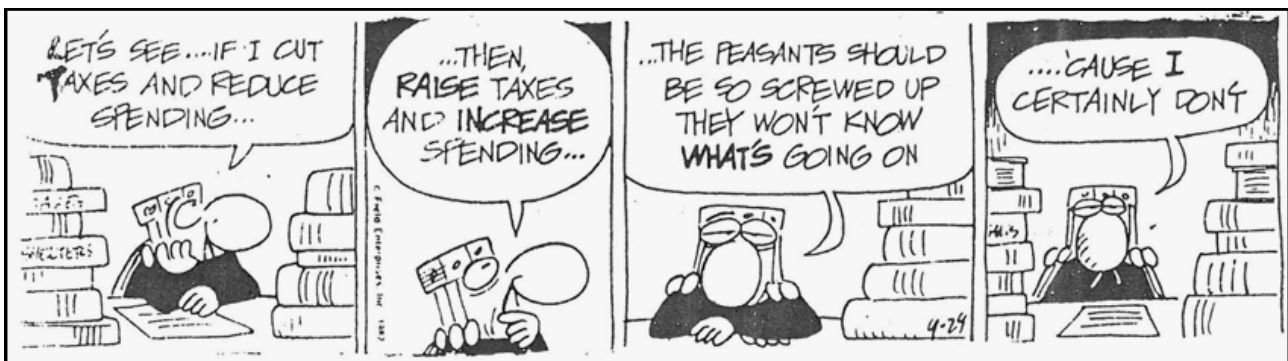
Look Through Company (LTC)

For income years beginning on or after 1 April 2011 companies that meet certain requirements can elect to be taxed as an LTC rather than a normal company.

In order to be an LTC the company must have 5 or fewer shareholders. There are special rules that apply to determine the number of shareholders in a LTC. Therefore, if new shareholders are introduced to a company which results in the 5 or fewer shareholder test being breached it will result in a deemed revocation of LTC status.

An LTC can only have one class of share. Therefore, if the shares in a company are reorganised so there is more than one class of share it will result in a deemed revocation of LTC status.

The tax implication of falling out of the LTC regime is that the shareholders are deemed to sell their share of the LTC's assets and liabilities at market value. This can result in tax being paid on what is ultimately unrealised profit.



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