Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > PRIVATE RULING

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKATAUNGA TŪMATAITI

Look-through company election

Decision date | Rā o te Whakatau: 27 March 2024

Issue date | Rā Tuku: 8 August 2024

TDS 24/16

Subjects | Kaupapa

Look-through company; look-through counted owner; available capital distribution amount; tainted capital gains

Taxation laws | Ture tāke

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

Summary of facts | Whakarāpopoto o Meka

1. The Arrangement in this ruling involves the Applicant, a company, electing to be a look-through company (the Election) and the liquidation of a wholly owned subsidiary (Subsidiary A).

2. The Applicant has three shareholder trusts – Trusts A, B and C. Each trust was settled by a sibling of a family (the Settlor). Each trust benefits the respective Settlor of the trust and a combination of their respective spouses, children, the children's spouses, their children and/or grandchildren, or family trusts that benefit these family members.

3. Trust A has a corporate trustee (the Corporate Trustee). The Corporate Trustee is wholly owned by the Settler of Trust A and has four directors (including the Settlor of Trust A). In the three income years prior to the Election, Trust A has made income distributions to a company that was wholly owned by the Corporate Trustee (the Beneficiary Company) and to a registered charity (the Charity). The Settlor of Trust A is also the settlor and a trustee of the Charity. The Charity has no ability to influence or control Trust A or the management of the Applicant. It is contemplated that the Charity will continue to receive distributions from Trust A.

4. At the time the Applicant was incorporated, the shares in a company (Subsidiary B) were transferred from the then shareholder to the Applicant. At the same time, Subsidiary B transferred its shareholding in Subsidiary A to the Applicant, giving rise to a capital gain for Subsidiary B. The Applicant and the Commissioner, at the time, agreed that this share-for-share exchange was subject to the available subscribed capital (ASC) limitation in s CD 43(9)-(14). As a result, the ASC in the Applicant was no more than the ASC that existed in Subsidiary B.

5. Further, for tax purposes, the Applicant and the Commissioner agreed on the cost of acquiring the shares in Subsidiary B incurred by the Applicant (the Agreed Amount).

Issues | Take

6. The main issues considered in this ruling were:

- Whether the Applicant met the requirement of having five or fewer "look-through counted owners".
- Whether the income distributions made to the Beneficiary Company and the Charity prior to the Election, and any future distributions made to the Charity, would prevent the Applicant from satisfying the definition of "look-through company".
- Whether the "cost" of the shares in Subsidiary B for the purposes of s CD 44 (and, therefore, when calculating the amount of the dividend under ss CD 26 and CB 32C) is the Agreed Amount.
- Following the liquidation of Subsidiary A, whether the gain derived by Subsidiary B on its disposal of the shares in Subsidiary A to the Applicant would be within s CD 44(10B).
- Whether s BG 1 applied to negate or vary the outcome to the above issues.

Decisions | Whakatau

7. The Tax Counsel Office (TCO) decided that:

- The Applicant has three "look-through counted owners" and therefore met the requirement of having five or fewer "look-through counted owners".
- The income distributions made to the Beneficiary Company and the Charity prior to the Election, and any future distributions made to the Charity, would not prevent the Applicant from satisfying the definition of "look-through company".
- The "cost" of the shares in Subsidiary B for the purposes of s CD 44 (and, therefore, when calculating the amount of the dividend under ss CD 26 and CB 32C) is the Agreed Amount.
- Following the liquidation of Subsidiary A, s CD 44(10B) would no longer apply to the gain derived by Subsidiary B on its disposal of the shares in Subsidiary A to the Applicant.
- Section BG 1 did not apply to negate or vary the outcome to the above issues.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: Look-through counted owners

8. For the Applicant to elect to become a look-through company (LTC), it can have only five or fewer "look-through counted owners".

9. Relevantly, under the "look-through counted owner" (LTCO) definition in s YA 1, the following are LTCOs:

   - A natural person who has derived beneficiary income arising from a direct or indirect beneficial interest in shares in an LTC, in the current income year or one of the last three income years (para (b)).
   - A natural person who receives a trust distribution in the current income year or one of the last three income years and the trust has a direct or indirect beneficial interest shares for the LTC (para (bb)).
   - A trustee of a trust (treating co-trustees as one person) with a direct or indirect beneficial interest in the shares in an LTC where no beneficiary of the trust is a LTCO (para (c)).
   - A natural person that has a voting interest or a market value interest for the LTC that has derived beneficiary income arising from a direct or indirect beneficial interest in shares for the entity for the current income year or one of the last three income years ((para d)).

10. Also relevant is paragraph (d) of the definition of "look-through company" which treats LTCOs who are relatives as one LTCO.

11. A "relative", as defined in s YA 1, includes a person within the second degree of blood relationship to a person; a spouse; and a spouse of a person who is within the second degree of blood relationship to a person.

12. To determine how many LTCOs the Applicant has, it was necessary to look through to the ultimate owners of the Applicant.

Trust A

13. In the three income years prior to the Election, Trust A made income distributions to:

    - The Settlor of Trust A and their children.
    - A family trust of which the Settlor and their children are beneficiaries.

- The Beneficiary Company.
- The Charity.

14. TCO concluded that the beneficiaries of Trust A, together, are considered a single LTCO for these reasons:

    - the Settlor and their children are all natural persons who derived beneficiary income from Trust A. Trust A has a direct beneficial interest in the shares of the Applicant. Therefore, paragraph (b) of the definition of LTCO applied. The Settlor and their children are treated as one LTCO because they are "relatives", being within two degrees of blood relationship to one another.
    - The Settlor and their children are also beneficiaries of the family trust and therefore have an indirect beneficial interest in the shares in the Applicant. However, as the Settlor and the children are "relatives", their interests in the family trust are not treated separately to their interest as natural persons. Therefore, the Settlor, their children and the family trust are treated as one LTCO.
    - The Beneficiary Company is not an LTCO. Paragraph (c) of the definition of LTCO applies where a trustee of a trust holds a beneficial interest in an LTC but has no beneficiaries that are LTCOs. In this case, the other beneficiaries of Trust A are LTCOs, so paragraph (c) cannot apply. None of the other paragraphs in the definition of LTCO applies.
    - The Charity is also not an LTCO. The Charity is not a named beneficiary of Trust A, nor does it own shares in the Applicant (either directly or indirectly). It has no control over Trust A or the Applicant. Therefore, paragraph (c) of the definition of LTCO does not apply. None of the other paragraphs in the definition of a LTCO applies.

Trust B

15. In the three income years prior to the Election, Trust B made income distributions to:

    - a family trust which made distributions to the Settlor of Trust B, their spouse, and the children's trust, and
    - through the children's trust, to the children, their children's spouses and their grandchildren.

16. Both the family trust and the children's trust have an indirect beneficial interest in the Applicant under paragraph (bb) of the LTCO definition. However, as the beneficiaries are "relatives", the Settlor of Trust B, their spouse and their children are treated as one LTCO.

Trust C

17. In the three income years prior to the Election, Trust C made income distributions to the Settlor of Trust C and their children.

18. As Trust C has a direct beneficial interest in the Applicant, but the Settlor and their children are "relatives", they are treated as one LTCO under paragraph (bb).

Overall number of LTCOs

19. Overall, the Applicant has three LTCOs, being the three shareholder trusts. The Charity is not an LTCO.

Issue 2 | Take tuarua: Distributions made to the Beneficiary Company and the Charity

20. Under the LTC provisions, an entity must meet all the requirements of the definition of LTC at all times in the income year in order to be eligible to be an LTC.

21. TCO considered whether the income distributions made to the Beneficiary Company and the Charity by Trust A prior to the Election would prevent the Applicant from meeting paragraph (eb) of the LTC definition in s YA 1. TCO also considered whether any future income distributions made to the Charity while the Applicant is an LTC would prevent the Applicant from meeting paragraph (ed) of the definition.

Distributions made to the Beneficiary Company – paragraph (eb)

22. Under paragraph (eb) of the LTC definition, if an entity is owned by a trustee of a trust, that entity cannot be an LTC if the trust makes a distribution to a company. The exceptions in paragraph (eb) do not apply here.

23. Therefore, any distributions made by Trust A to the Beneficiary Company once the Applicant is an LTC could cause it to lose LTC eligibility.

24. However, the LTC definition sets out the requirements an LTC must meet *in the income year* that the entity is an LTC. It does not refer to distributions being made in previous years. Therefore, the distributions made to the Beneficiary Company *before* the Applicant's Election would not prevent it from qualifying as an LTC. This is further confirmed by ss HB 1 and HB 13 which provide further details on what an LTC must to do for the income year it wishes to become and continue to be an LTC.

Distributions to the Charity – paragraph (ed)

25. Under paragraph (ed) of the LTC definition, if an entity is owned by a trustee of a trust, that entity cannot be an LTC if the trust makes a distribution of income to a tax charity that is a beneficiary of the trust, unless the tax charity has no control or influence in relation to the operation of the entity or to the distributions of the trust.

26. Like paragraph (eb), paragraph (ed) only applies in the income years that the Applicant is a LTC, therefore, any past distributions made by Trust A to the Charity would not prevent the Applicant from qualifying as an LTC.

27. The Charity is a registered charity and a discretionary beneficiary of Trust A. Therefore, any intended future distributions to the Charity once the Applicant is an LTC could cause it to lose LTC eligibility, unless the Charity has no control or influence over the operation of the Applicant or to the distributions of Trust A.

28. In that regard, TCO considered that there is nothing in the trust deed of either Trust A or the Charity to indicate that the two trusts are linked, apart from the Settlor of Trust A being the settlor of both trusts. When the Settlor of Trust A is carrying out their trustee duties in relation to each trust, they are required to act in the best interest of that trust. TCO did not consider that a shared trustee was sufficient to conclude that the Charity had any control or influence over the Applicant or Trust A.

29. In addition, the Charity does not have any voting interests in the Applicant, and so is unable to control or influence the operation of the Applicant, nor was there evidence to suggest that the Charity has any control or influence over the actions of Trust A, particularly in relation to distributions.

30. Therefore, TCO concluded that any future distributions made to the Charity by Trust A would not cause the Applicant to lose its eligibility to be an LTC under paragraph (ed).

Issue 3 | Take tuatoru: Cost of shares in Subsidiary B

31. Section CB 32C applies when a company becomes an LTC. It gives rise to an amount of dividend income for any person with an effective look-through interest in the company.

32. TCO was asked to confirm that when calculating the amount of dividend, the cost of the shares in Subsidiary B held by the Applicant is the Agreed Amount.

33. In calculating the amount of income under s CB 32C, the Applicant must determine the amount that would be a dividend as if the Applicant had:

- disposed of all its property to an unrelated person at market value; and

- met all its liabilities at market value; and
- was then liquidated and distributed the remaining cash to its shareholders.

34. Section CD 26 provides that when a company is liquidated, a dividend arises for the shareholders to the extent that the amount paid to them exceeds the sum of the available subscribed capital (ASC) and available capital distribution amount (ACDA).

35. Section CD 44 is relevant in this case to determine the ACDA amount using the formula in s CD 44(1). The relevant item in the formula considered in this ruling is the amount of capital gains that are available for distribution (as defined in s CD 44(2)(c)).

36. Under s CD 44(7)(a), a capital gain arises to the extent that the market value of the capital asset is more than the "cost" of the asset to the company. If the market value of the shares in Subsidiary B is more than the cost of the shares to the Applicant, that difference is the capital gain and that amount would be excluded from being a dividend under ss CD 26 and CB 32C(6).

37. From case law, TCO determined that "cost" is what must be given in order to acquire something. It is generally viewed as an objectively determinable historical fact — the answer to the question of how much was paid.[1]

38. In the current case, the Applicant and Commissioner had previously agreed on the cost the Applicant incurred to acquire the shares in Subsidiary B.

39. Therefore, TCO confirmed that the cost of the shares in Subsidiary B was the Agreed Amount for the purposes of s CD 44 (and therefore, when calculating the amount of the dividend under ss CD 26 and CB 32C).

Issue 4 | Take tuawhā: Section CD 44(10B)

40. When the Applicant was incorporated, Subsidiary B derived a capital gain when it transferred the shares it held in Subsidiary A to the Applicant. In accordance with s CD 44(10B), that capital gain would not be included in the ACDA of Subsidiary B because the gain arose from a disposal of property to a company in the same wholly owned group.

41. TCO was asked to confirm that s CD 44(10B) would no longer apply in relation to the capital gain once Subsidiary A has been liquidated.

42. Section CD 44(10B) provides that no capital gain is derived when property is sold between companies that have at least 85% common ownership, both at the time the

[1] *Tasman Forestry Ltd v CIR* (1999) 19 NZTC 15,147 (CA); *Wilke v CIR* (1998) 18 NZTC 13,923.

property is sold and at the time of the liquidation distribution. The property in question is the shares in Subsidiary A.

43. Once Subsidiary A is liquidated, it will be removed from the Companies Register — Subsidiary A and the shares in Subsidiary A will cease to exist. This means that the relevant property for the purposes of s CD 44(10B) will cease to exist.

44. Consequently, there will be no commonality of ownership as there is no company that owns part of the property for the purposes of s CD 44(10B)(b), and therefore no "owning company". Further, the "ownership interest" will be zero, as nobody owns the property.

45. Therefore, TCO concluded that s CD 44(10B) would no longer apply to prevent the gain arising from the disposal of shares in Subsidiary A from being a capital gain amount when determining the ACDA of Subsidiary B.

Issue 5 | Take tuarima: Section BG 1 – tax avoidance

46. Section BG 1(1) provides that a "tax avoidance arrangement" is void as against the Commissioner. Section GA 1 enables the Commissioner to make an adjustment to counteract a tax advantage obtained from or under a tax avoidance arrangement.

47. The Supreme Court in *Ben Nevis Forestry Ventures Ltd v CIR* [2008] NZSC 115, [2009] 2 NZLR 289 considered it desirable to settle the approach to applying s BG 1. This approach is referred to as the Parliamentary contemplation test, which is an intensely fact-based inquiry. *Ben Nevis* has been followed in subsequent judicial decisions.

48. The Tax Counsel Office's approach in making this decision is consistent with Interpretation Statement: IS 23/01 Tax avoidance and the interpretation of the general anti-avoidance provisions sections BG 1 and GA 1 of the Income Tax Act 2007 (3 February 2023) (IS 23/01). IS 23/01 will not be replicated in this TDS but in summary the steps are as follows:

- Understanding the legal form of the arrangement. This involves identifying and understanding the steps and transactions that make up the arrangement, the commercial or private purposes of the arrangement and the arrangement's tax effects.
- Determining whether the arrangement has a tax avoidance purpose or effect. This involves:
    - Identifying and understanding Parliament's purpose for the specific provisions that are used or circumvented by the arrangement.

- Understanding the commercial and economic reality of the arrangement as a whole by using the factors identified by the courts. Artificiality and contrivance are significant factors.
- Considering the implications of the preceding steps and answering the ultimate question under the Parliamentary contemplation test: Does the arrangement, when viewed in a commercially and economically realistic way, make use of or circumvent the specific provisions in a manner consistent with Parliament's purpose?

- If the arrangement has a tax avoidance purpose or effect that is not the sole purpose or effect of the arrangement, consider the merely incidental test. The merely incidental test considers many of the same matters that are considered under the Parliamentary contemplation test.

49. Taking into account all of the relevant facts and circumstances (noting that as this is a summary it may not contain all the facts or assumptions relevant to the decision and, therefore, cannot be relied on) the Tax Counsel Office concluded as follows.

The Arrangement and its tax effects

50. The Arrangement for s BG 1 purposes is the election of the Applicant to be an LTC, together with the liquidation of Subsidiary A. The election is made in accordance with s HB 13.

51. According to the agent of the Applicant, the commercial or private purposes of the Arrangement are to enable the shareholders of the Applicant to have better access to dividends and capital gains which might arise should any of its long-term investments be realised. The Applicant had recently undertaken a review of its structure with this purpose in mind. Various options were considered and electing into the LTC regime was the chosen option.

52. TCO considered that the Arrangement gave rise to the following tax effects:

- Once the Applicant is an LTC, it will be transparent for tax purposes, with all of its income, expenses, gains and losses allocated to its shareholders (s HB 2). In terms of the Applicant's eligibility to become an LTC:
  - The Applicant has three LTCOs.
  - The Charity is not an LTCO.
  - Past distributions made to the Beneficiary Company and the Charity, and any future distributions made to the Charity, would not prevent the Applicant from being an LTC.

- On election into the LTC regime, a dividend arises for the shareholders of the Applicant, calculated in accordance with s CB 32C. For the purposes of s CD 44 (and, therefore, when calculating the amount of the dividend under ss CD 26 and CB 32C), the "cost" of the shares in Subsidiary B is the Agreed Amount.
- Following the liquidation of Subsidiary A, the gain derived by Subsidiary B on its disposal of the shares in Subsidiary A to the Applicant will not be within the scope of s CD 44(10B). This capital gain was previously "tainted" as the shares in Subsidiary A had been sold to a related party. (As Subsidiary B is not being liquidated as part of this Arrangement, this tax effect is only relevant to the calculation of Subsidiary B's ACDA in the future.)

53. By electing to be an LTC, the overall tax effect is that the Applicant would be treated as if it had been liquidated and then it would be able to distribute capital gains to its shareholders tax-free.

Tax avoidance purpose or effect – parliamentary contemplation

54. The Applicant's decision to elect into the LTC regime was to allow the shareholders to retain administrative and financial reporting simplicity, while also allowing tax-free capital gains (eg, from the sale of assets) to be paid out to the family without requiring the liquidation of the Applicant.

55. TCO considered that the tax effects of the Arrangement were all contemplated by Parliament. This is because:

- The shareholders of the Applicant are three trusts that hold the interests of three siblings and their families. It is clear the three family groups have effective control of the Applicant and are therefore within the intended scope of the LTC regime.
- In terms of the Applicant's eligibility to elect to be a LTC, Parliament would not have intended that distributions made to the Charity, being an unnamed discretionary beneficiary of one of the owning trusts, would impact on the Applicant's eligibility. It is clear from the terms of the legislation that Parliament intended that an LTC could make distributions to a charity, as long as the charity could not control the LTC.
- There is no artificiality in the fact that the Applicant qualified to elect to be an LTC, given its nature as a family-owned business.
- The LTC regime provides special rules for the taxation of closely held companies. The treatment of LTCs as transparent is clearly provided for by the legislation and was intended by Parliament. Once a valid election is made to be an LTC, the tax

consequences that arise from that election are also clearly contemplated by Parliament.

- Once an entity becomes an LTC, capital gains are able to be distributed to shareholders tax-free, with s CB 32C providing for a dividend to arise on entry into the LTC regime that effectively triggers a tax liability on any unimputed retained earnings of the company. In calculating the amount of dividend, the LTC is required to be treated as though it had sold all its assets to a third-party and had been liquidated. This requires the cost of the relevant asset to be taken into account. In this Arrangement, Parliament would have intended that the 'cost' of the shares in Subsidiary B to be the amount that was agreed earlier between the Applicant and the Commissioner, and Parliament would expect that the Commissioner respects that agreement.
- Section CD 44(10B) highlights that Parliament was concerned that the sale of assets between companies with significant commonality of ownership could recharacterize revenue gains as capital gains for the purpose of the ACDA calculation. Based on the requirements of the provision, Parliament intended that in situations where an asset ceases to exist (whether due to a sale to a third-party or otherwise), s CD 44(10B) would no longer apply, and the capital gain would become available.

56. TCO concluded that Parliament would consider that the Arrangement made use of the relevant provisions in a manner that is consistent with Parliament's purpose for those provisions. Therefore, the Arrangement does not have a tax avoidance purpose or effect.

57. As TCO have concluded that there is no tax avoidance purpose or effect of this Arrangement, it was not necessary for TCO to consider whether the Arrangement was a "tax avoidance arrangement" or to consider the merely incidental test.

58. It was concluded that s BG 1 did not apply to negate or vary the conclusions in this ruling.