Tax Working Group Information Release

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Coversheet: Domestic Share issues with taxing more capital gains

Position Paper for Session 22 of the Tax Working Group
8/9th November 2018

Purpose of discussion

This paper outlines some of the issues associated with extending the taxation of capital gains with particular reference to sales of shares in resident companies. It provides recommendations and/or options for addressing the issues raised.

This paper canvasses the issues of:

- imputation credit continuity;
- double taxation of unrealised gains/losses in companies;
- available subscribed capital/cost base; and
- the potential for repealing the qualifying company tax regime.

Key points for discussion

The Group's views on the recommendations made by officials in relation to the issues arising from sales of domestic shares. In particular:

- the relaxation of the imputation credit continuity rules;
- that the introduction of a tax on capital gains reduces any need for changes be made to the loss continuity rules;
- adjustments to the cost basis of shares is required when losses are offset without full consideration paid;
- deeming a sale of assets rather than shares where assets have unrealised gains or losses (on an optional basis for gains and compulsory in certain circumstances for losses);
- repeal of the qualifying company regime.

Recommended actions

If tax on capital gains is extended, we recommend that you:

a **agree** that officials should consult with interested parties on the detail of the options for reducing double tax and double deduction issues on the sale of domestic shares.

b **agree** to relax the imputation credit continuity provisions by replacing these with a quarantining rule for credits generated while a company is owned by non-residents or tax-exempt entities.

c **note** that the ability of shareholders to claim a deduction for losses on shares reduces any pressure to change the current ownership continuity rule for losses

d **agree** to introduce rules to adjust the cost base of shares in companies that make and receive loss offsets.

e **agree** to introduce rules to deem the sale of shares in a company to be the sale of the underlying assets on a compulsory basis where the company sold has assets with total net tax bases that are substantially higher than the sale price of the shares

f **agree** to modify the rules around distributions of capital gains on liquidation to limit this to gains that arose prior to an extension of the taxation of capital gains and to ensure funds received from the liquidation excluding dividends, are considered consideration for the sale of shares.

g **agree** to repeal the qualifying company regime and allow existing qualifying companies to transition to normal or look through companies with appropriate cost base adjustments for distributions.

Domestic share issues with taxing more capital gains

Position paper for Session 22
of the Tax Working Group

November 2018

Prepared by Inland Revenue and Treasury

TABLE OF CONTENTS

Executive Summary 6

1. Introduction 9

1.1 Purpose 9

1.2 Content and scope 9

2. Double taxation of realised gains: imputation credit continuity 10

2.1 Context 10

2.2 Purpose of the imputation credit continuity rule 11

2.3. Effect of making all share sale gains taxable 12

2.4 Recommendation 13

3. Realised losses: double deduction issues 14

3.1 Context 14

3.2 Other jurisdictions 17

3.3 Recommendation 18

4. Unrealised gains and double taxation 19

4.1 Context 19

4.2 Policy problem or opportunity 19

4.3 Recommendation 21

5. Unrealised losses and double deductions 22

5.1 Context 22

5.2 Policy problem or opportunity 22

5.3 Other jurisdictions 23

5.4 Recommendation 23

6. Distribution of untaxed gains made prior to taxing more capital gains 24

6.1 Context 24

6.2 Policy problem or opportunity 24

6.3 Loss on liquidation 26

6.4 Recommendation 27

7. Qualifying companies 28

7.1 Context 28

7.2 Policy problem or opportunity 28

7.3 Options 29

7.4 Recommendation 32

5. Conclusion and recommendations 34

Appendix A: Suggested text for final report 35

Executive Summary

In the *Interim Report* the Group expressed the view that in many cases, double taxation issues are able to be managed without the need for legislative change. However, it identified the following issues as requiring further consideration:

a. The appropriateness of the current rule which eliminate imputation credits on a change of ownership of more than 34% in a company.
b. How best to prevent realised losses in a company giving rise to a double deduction on sale of the company.
c. Whether double taxation arising on a sale of shares in a company with appreciated assets should be dealt with by allowing the parties to treat the transaction as a sale of assets for tax purposes.
d. What rule would be appropriate to prevent unrealised losses in a company giving rise to a double deduction.
e. What rules might be necessary to ensure that capital gains arising before the valuation date remain able to be distributed by a company on a tax-free basis.
f. The repeal of the qualifying company regime.

Double taxation of realised gains – imputation credit continuity

Taxing capital gains on the sale of shares raises a risk of double taxation on the company income if it is not distributed prior to sale. The scope of this problem seems limited:

a. Data shows that public companies tend not to accumulate imputation credits, so for those companies, there is little accumulation of taxed company income that is potentially subject to double tax.
b. While private, closely held companies do accumulate imputation credits they have the ability to remove double taxation before a sale of company shares by paying an imputed dividend or making a taxable bonus issue.
c. If double taxation is not prevented by a pre-sale dividend or taxable bonus issue it is reversed once the company distributes the earnings to the purchaser with imputation credits attached. However, the current rules around imputation credit continuity will prevent the reversal where there is a change in the ownership of the company of greater than 34%.

The purpose of the imputation credit continuity rule is to prevent the inappropriate transfer of tax benefits to those with a tax rate that is lower than the owner of the company at the time the credits were generated. It also prevents trading in imputation credits.

If all share gains become taxable, this rationale for the imputation continuity rule largely disappears. A shareholder cannot escape tax at its marginal rate on the company's retained earnings by selling its shares. However, if the shareholder is not taxable on the sale by virtue of being tax exempt or non-resident:

a. there are no double taxation issues, since the shareholder is not taxable on the sale of the retained earnings; and
b. a transfer of the company to shareholders on a rate below 28% would not be appropriate.

Officials consider that the current imputation credit continuity rules can be relaxed after any extension of tax to domestic share sales. We consider that the Australian model of quarantining credits that arose during the ownership of the company by non-residents or tax-exempt entities is a more appropriate form of imputation continuity.

Double deduction of realised losses

In most cases the possibility of a double deduction for realised losses is limited due to the loss continuity rules. The one case where this would not apply is when the loss of a company is offset within a corporate group other than by way of subvention payment.

In that case the Group recommended, in the *Interim Report,* cost base adjustments to the shares in both the company offsetting and receiving the loss be adjusted to ensure that deductions are not able to be claimed twice. Officials continue to have the view that that the extension of tax to share gains and losses should reduce any pressure to change the current rule eliminating losses in a company on a 51% change of ownership.

Unrealised gains

Double taxation can arise when a company which has unrealised gains relating to its assets is sold. It is possible that these gains can be realised once through the sale of shares as the purchase price reflects those gains and once when the assets are sold by the company.

There are two possible approaches to dealing with this issue. The first is to do nothing. In general, when someone purchases a company with assets it will want to hold those assets for a period of time. They will not generally want to immediately dispose of those assets. The passage of time will reduce the issue of double taxation.

A second option would be to deem the sale of shares to be the sale of the underlying assets of the company. As this option would require the valuation of the assets, and the double taxation issue is likely to only be an issue if the purchaser wants to dispose of the assets in the short term, we recommend that this process be optional in relation to unrealised gains.

Unrealised losses

Mirror issues apply for companies with unrealised losses which, without intervention, could result in the double deduction of that loss. In most cases these issues will result in minor issues when small amounts of shares are traded, however, there is a concern when a large proportion of the shares in a company are disposed of. This could result in some large avoidance opportunities which is undesirable.

These issues could be addressed using the same mechanism that we have recommended to address unrealised gains, however, in respect of unrealised losses this would be compulsory.

As the concern in this area is for major changes in shareholding, we would recommend limiting the application of that rule to share sales of 50% or more of the company where the company is sold for a sale price that reflects a valuation of the company at less than 80% of the net tax value of its business.

Distribution of pre-tax gains

In its *Interim Report* the Group considered that under an extended tax on capital gains the current rules relating to distributions on liquidation would not need to change.

Officials do not believe any special rules are required to deal with this issue. However, some modifications may be required to ensure:

a. only capital gains made prior to the extension of tax on capital gains are passed to shareholders tax-free on a liquidation; and
b. any funds or assets received by shareholders on liquidation are consideration for the disposal of those shares, to the extent that they are not dividends.

Qualifying companies

The QC regime has two benefits:

a. Shareholders can sell out of the business by selling the shares rather than selling assets and crystallising tax labilities (pre-dating the extension of capital gains tax); and
b. Capital gains can be passed out to shareholders tax free without liquidating the company.

Under a more comprehensive taxation of capital gains the main reason for having a QC is removed. As all capital gains will be subject to tax there is no need for the ability to pass through capital gains tax-free to shareholders of QCs as they will be taxable in any case and should carry imputation credits.

This is true for the earnings of a QC after the extension of tax on capital gains. However, for those retained earnings of a QC at the time of introduction where these comprise capital gains this should continue to be available to be passed through to shareholders of a QC tax-free (as is proposed for normal companies which liquidate).

There are two possible options, the first is to retain the QC regime and the second is to remove the regime and allow QCs to transition to normal companies or become LTCs. Either way, it is probably appropriate to allow QCs or ex-QCs, to distribute pre-valuation day capital gains, both realised and unrealised, free of tax.

As the main reason for the existence of qualifying companies, (the ability to pass out capital gains tax free to shareholders), is removed by a tax on capital gains, officials consider the qualifying company regime should be removed and existing qualifying companies should be required to transition to normal or look through companies.

1. Introduction

1.1 Purpose

1. This paper provides the Group with options for addressing six issues left open in the *Interim Report*, regarding changes that might need to be made to the taxation of shareholders in New Zealand companies in the event that gains on sale of shares become subject to tax.

1.2 Content and scope

2. Appendix B to the *Interim Report* concluded that taxing the gain on the sale of shares was a necessary part of any comprehensive extension of capital gains taxation, but it did give rise to some issues[1].

3. New Zealand's imputation system effectively treats a company as an agent for its shareholders. The company derives income in its own capacity, but it also derives that income for the benefit of shareholders.

4. That income should be taxed at the company level *or* the shareholder level but not both (the same applies for a loss incurred by a company – only one deduction should arise for tax purposes). Taxing capital gains on the sale of shares raises a risk of double taxation or double deductions on the company income or loss.

5. The *Interim Report* expressed the view that in many cases, double taxation issues are relatively small or able to be dealt with by companies and investors. However, it identified the following issues as requiring further consideration:
    - The appropriateness of the current rule which eliminates imputation credits on a change of ownership of more than 34% in a company (paragraph 155).
    - How best to prevent realised losses in a company giving rise to a double deduction on sale of the company (paragraph 161).
    - Whether double taxation arising on a sale of shares in a company with appreciated assets should be dealt with by allowing the parties to treat the transaction as a sale of assets for tax purposes (paragraphs 158-159).
    - What rule would be appropriate to prevent unrealised losses in a company giving rise to a double deduction (paragraph 163).
    - What rules might be necessary to ensure that capital gains arising before the valuation date remain able to be distributed by a company on a tax-free basis on liquidation (paragraph 172).
    - The repeal of the qualifying company regime (paragraph 171).

6. This paper considers each of these issues.

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2. Double taxation of realised gains: imputation credit continuity

2.1 Context

7. There are several situations where realised gains/losses within a company can lead to double taxation when the sale of the shares is taxed. These issues arise now when the shares are held on revenue account. The extension of tax on capital gains will make the issue more widespread.

8. New Zealand has an imputation system which prevents double taxation when income earned by a domestic company is taxed to the company and is later distributed as a dividend. By attaching an imputation credit, the company allows the shareholder to reduce its tax on a dividend by the company tax already paid on the income.

9. The net effect is the tax rate on the distributed income is adjusted to the shareholder's tax rate. A shareholder on 33% must pay an additional 5% top-up tax, and shareholders on tax rates below 28% get an excess imputation credit which can be used against tax on other sources of income, effectively reducing the tax rate on the income from the company tax rate to the shareholder's tax rate. For example, if a company earns $200 and pays $56 of tax, the after-tax amount of $144 can be distributed along with an imputation credit of $56. For a shareholder on a 33% tax rate, the receipt of such a dividend will trigger a tax obligation of a further $10 ($200 x 33% - $56).[2]

10. Taxing capital gains on the sale of shares raises a risk of double taxation on the company income. If accumulated income is not distributed, its retention raises the share price. The shareholder would then sell the shares for a taxable capital gain. For example, suppose a company earns $200 and pays $56 of tax which it does not distribute. When the shareholder sells the company, the share price will be higher because of that undistributed income. Suppose it is increased by $160.[3] In that case the sale will trigger a further $52.80 tax liability. The Government has received $108.50 of tax, on only $200 of income.

11. The scope of this problem seems as a practical matter to be limited.

    - Data shows that listed companies tend not to accumulate imputation credits, so for those companies, there is little accumulation of taxed company income that is potentially double taxed.
    - While unlisted companies do accumulate imputation credits, they have the ability to remove double taxation before a sale of company shares by, for example, paying an imputed dividend or making a taxable bonus issue. This will reduce the tax payable on sale, by either reducing the sale price (if a

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[2] These examples ignore the application of resident withholding tax for simplicity.

[3] The amount should be between $144 and $200, depending on how much the purchaser is prepared to pay for the imputation credits.

dividend is paid) or increasing the shareholder's cost base (if the company makes a taxable bonus issue).

- If double taxation is not prevented by a pre-sale dividend or taxable bonus issue, it is reversed once the company distributes the earnings to the purchaser (with imputation credits attached) and the purchaser sells the shares. For example, take the case where the purchaser pays $160 extra for a company because of its tax paid retained earnings of $144. The purchaser can receive a fully imputed dividend of $144, paying an additional $10 of tax, the same amount as the vendor would have paid if it received the dividend (this assumes vendor and purchaser are on the same tax rate). When the purchaser later sells the shares, their value will be reduced by $160 (assuming there has been no other change to the company's value than that produced by payment of the dividend). This reduces the purchaser's taxable income (or increases its loss) when it sells the shares by $160 (equal to a tax benefit of $52.80 for a 33% taxpayer), to match the vendor's gain of $160. The double taxation is eliminated.[4]

12. However, as noted in the *Interim Report*, under current law, imputation credits generated by payments of tax are eliminated if there is a change in the ownership of the company of more than 34% since the tax was paid (this is referred to as the "imputation credit continuity rule". If the credits are eliminated, the double tax arising by virtue of the sale cannot be reversed by a subsequent dividend and on-sale. Accordingly, the *Interim Report* suggested that consideration be given to whether the imputation credit continuity rule could be replaced without risk to the revenue.

2.2 Purpose of the imputation credit continuity rule

13. The purpose of the imputation credit continuity rule is to prevent the inappropriate transfer of tax benefits. For example, suppose the company considered above is sold to a taxpayer with annual income for the year of $40,000 (and thus a marginal tax rate of 17.5%), and there is no imputation credit continuity rule. In most cases, the vendor is not taxed on the sale, because the shares are held on capital account. After sale, the $144 retained earnings can be paid to the buyer on a fully imputed basis. The buyer will have no tax to pay on this sum and will be able to use the $21 of excess credits ($200 x 17.5% – $56) to reduce the tax on other income. Revenue is reduced by $31 overall, being the difference between tax on $200 at 17.5% (the buyer's marginal tax rate) and tax on the same amount at 33% (the seller's marginal rate). In the absence of an imputation credit continuity rule, a similarly revenue-negative outcome occurs if:
    - a non-resident or tax exempt shareholder sells a company with imputed earnings to a person on a tax rate below 28%; or

[4] This kind of transaction is problematic if the vendor is a non-resident or tax exempt, so that there is no double taxation to correct. This is presumably the reason for Australia's "at risk" rules, which deny imputation credits to shareholders who do not meet a minimum holding period. New Zealand has a similar rule in section FA 3 of the Income Tax Act 2007, which denies the loss if the dividend can be regarded as part of the sale price of the shares. This rule will need to be reconsidered if all shares sales become taxable.

- a taxpayer on a 33% or 30% rate sells a company to a non-resident or tax-exempt taxpayer.

14. However, the scope for this revenue-negative outcome to occur would be limited even if there were no imputation credit continuity rule. The 33% rate applies to incomes over $70,000, so there is no tax benefit in transferring a dividend larger than that to a resident taxpayer. And a low tax-rate purchaser has to have sufficient pre-tax income to use the excess imputation credits. Furthermore, the imputation credit continuity rule means that imputation credits are lost even where there is no tax benefit involved (e.g., the sale of shares from one taxpayer on a 33% rate to another). A transfer to a tax-exempt or non-resident investor will enable income distributed through a fully-imputed dividend to be distributed with no additional tax, but the rate of tax on income distributed through an imputed dividend cannot be reduced below 28% by attaching imputation credits, because credits are not refundable.

15. Officials also acknowledge that the imputation credit continuity rule currently serves a purpose of preventing more aggressive imputation credit trading transactions, for example where fully taxed earnings are extracted from a company while leaving the imputation credits in place and able to be sold separate from the earnings that gave rise to them. Targeted rules may be necessary to address this.

2.3. Effect of making all share sale gains taxable

16. If all share sale gains become taxable, the purpose for the imputation credit continuity rule largely disappears. A vendor cannot escape tax at its marginal rate on the company's retained earnings by selling its shares. However, if the vendor is not taxable on the sale because it is a non-resident or tax exempt:

    - there is no double taxation issue, since the vendor is not taxable on the sale of the retained earnings; and
    - a transfer of the company to shareholders on a rate below 28% (such that a distribution of the retained earnings to them would adjust the tax rate on those earnings to less than 28%) would not be appropriate in policy terms.

17. We understand that Australia's imputation continuity rule is much less stringent than the New Zealand rule. The Australian rule segregates tax credits generated while a company is owned 95% or more by non-residents or tax-exempt entities, to prevent imputation credits generated during that period being used to reduce income tax. Such credits can only ever be used to exempt a dividend from non-resident withholding tax. Transfers between residents, or indeed between non-residents, have no effect on the imputation credit account.

18. If the taxation of capital gains is extended, there does not seem to be a case for our current imputation credit account continuity rules in relation to transactions between taxable residents.

2.4 Recommendation

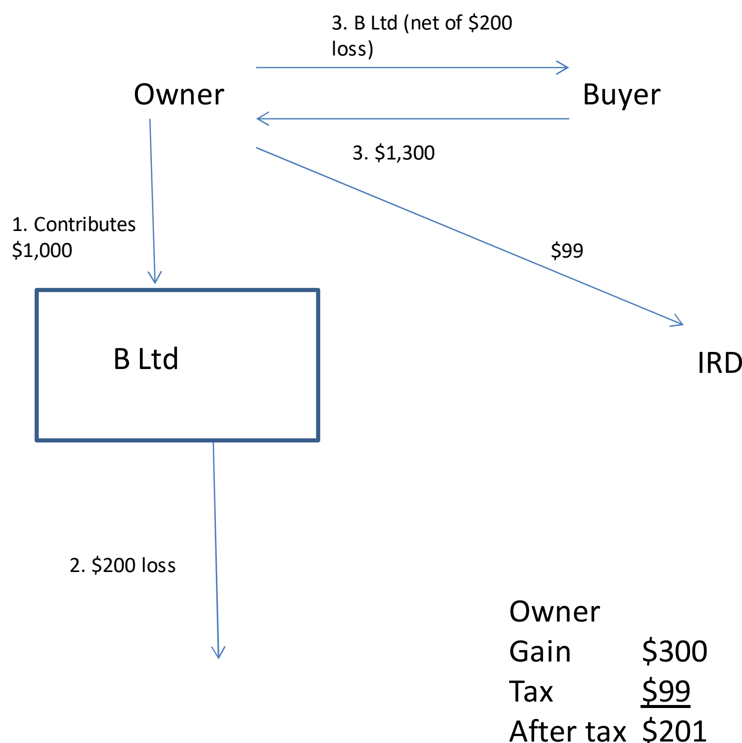
19. Officials believe that the Group should maintain the view expressed in its *Interim Report*, that the imputation continuity requirements be relaxed under an increase in the taxation of capital gains with a view to better targeting these requirements as an anti-avoidance provision that disallows or quarantines credits arising while a company is owned by tax exempt or non-resident owners, and having no effect on changes of ownership between New Zealand taxable residents.

3. Realised losses: double deduction issues

3.1 Context

20. Similar to the issue of double taxation on realised gains, where a shareholder sells shares in a company with retained losses, double deductions can arise.

Example one: (all taxes assumed to be 33%)



21. B Ltd has a tax loss of $200 which is unused at the date of sale. The owner (on a 33% tax rate) sells the company for $1,300, a gain of $300, presumably reflecting the combination of the loss-depleted assets and some untaxed appreciation in the company, such as an increase in the value of its goodwill or some other intangible asset. As the company's valuation is established by the share sale price, this increase must have a value of $500. The Owner effectively has the benefit of the tax loss, embedded in the sale price of B Ltd. Rather than paying tax on the full $500 increase in the assets, the Owner pays tax of only $99, on the net $300.

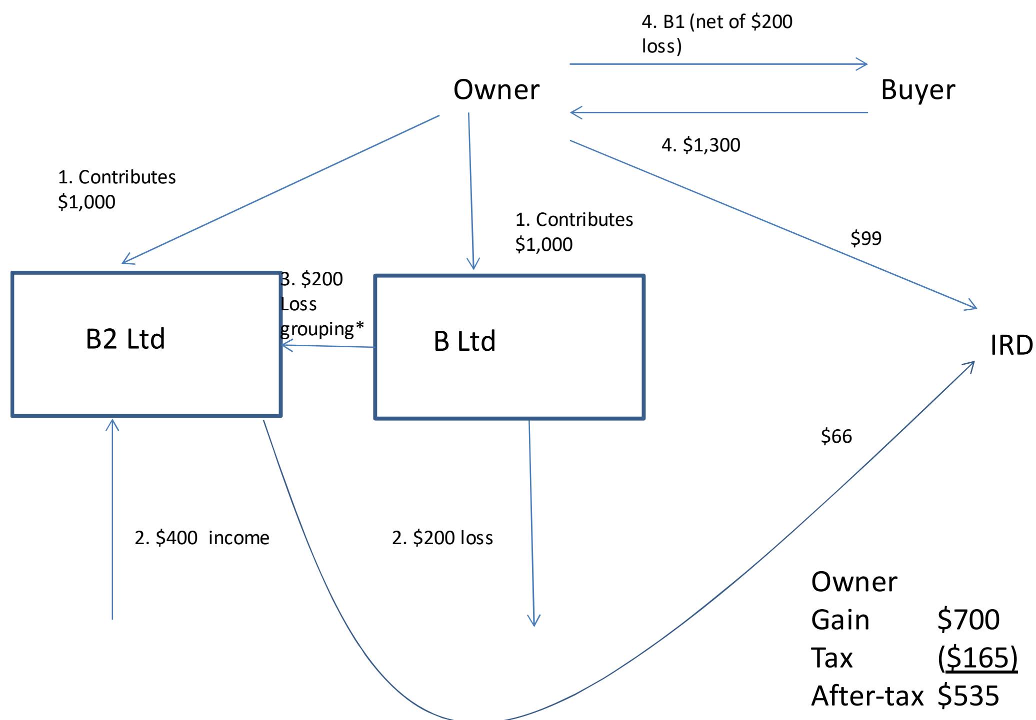
22. The sale will eliminate the tax loss due to the continuity of loss rules that require a 49% continuity of shareholding to carry forward the loss. This outcome is appropriate, because the Owner benefitted from the loss when it sold the shares.

23. If the loss were not eliminated on sale, the buyer could generate $200 of income in B Ltd without paying tax. Any tax benefit would be clawed back on distribution of the income to the buyer or a subsequent shareholder, but this might not occur for some

time. Until then, a single loss will have offset two separate amounts of income. This suggests that, if all share gains and losses become taxable and deductible, there is less need to relax the loss ownership continuity rule[5].

24. Another possibility is where the company is able to offset its loss with another group company or within a tax consolidated group prior to the sale of shares.

Example two: (all taxes assumed to be 33%)



25. In example two, before the sale, B Ltd uses its loss by way of a loss offset election against the income of a sister company (B2 Ltd), owned by the same Owner (in the example, both the corporate and individual rates are assumed to be 33%).

26. On sale, the Owner will make a taxable gain of $300 ($1,300 sale price less the $1,000 cost of the shares). This means that in total the Owner will make a taxable gain of $500, even though its economic income is $700 ($300 due to its sale of B Ltd and $400 due to its ownership of B2 Ltd). The result is that the loss in B Ltd is used twice, once by way of reducing the Owner's income reflected in the $1,300 sales price and once by reducing B2 Limited's income. This is obviously not appropriate. The benefit will be recaptured when the loss-sheltered income in B2 Ltd is distributed, however, that could be some years later.

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[5] Officials acknowledge that where an ownership change occurs by virtue of an issue of new shares, the change is not accompanied by immediate recognition of a loss, and so the imposition of a tax on capital gains does not have the same effect of allowing the loss to an owner on an immediate basis. However, a loss will arise when the shareholder does sell its shares.

27. The *Interim Report* refers to the possibility of adapting an existing provision in the Income Tax Act, section DB 24[6]. In fact, this should not be necessary if the proposal considered in the *Interim Report* in relation to the taxation of corporate groups applies.

28. Under this proposal, where a company groups a loss with another company, the cost base of every shareholder in the loss company is decreased, and the basis of every shareholder in the profit company is increased, by the amount of the loss less any compensation payment made for the loss.

Example three: (all taxes assumed to be 33%)

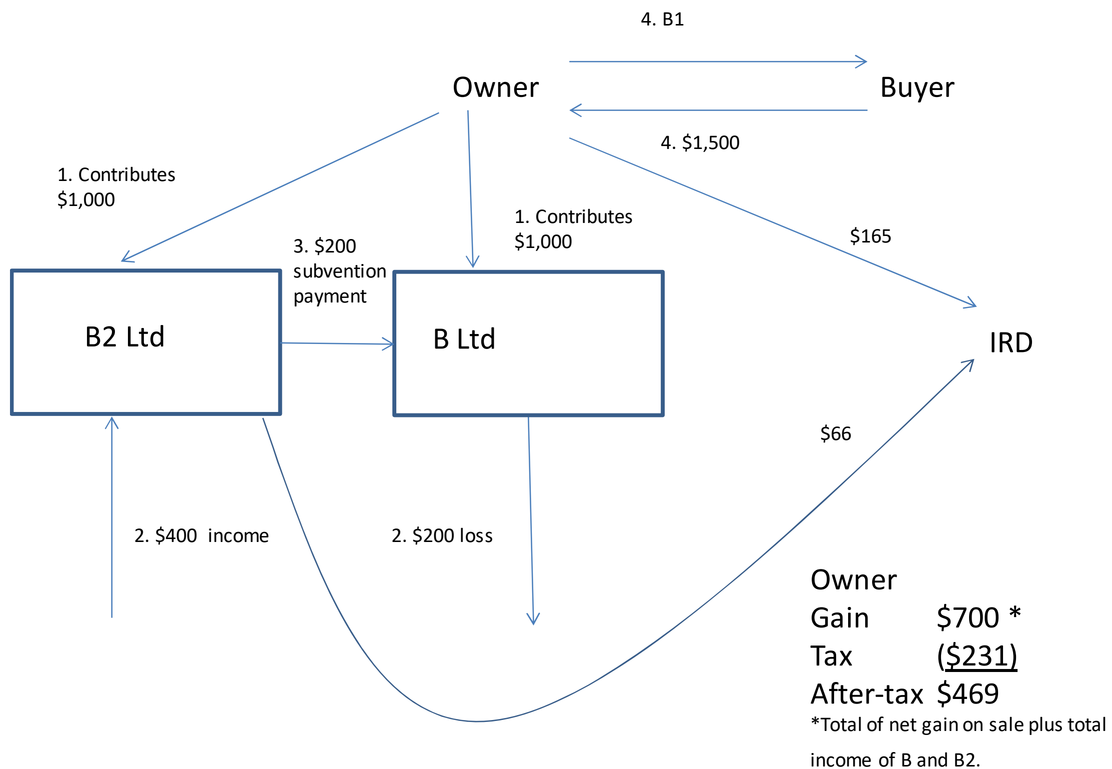
29. Continuing example two above such a rule would result in the cost base of the Owner's shares in B Limited being reduced by $200 which is the loss offset between B Ltd and B2 Ltd. This would result in the owner's gain being $500 instead of $300 and eliminate the double deduction for the loss.

30. The total gain to the owner will then be $700 ($500 on sale of the shares and $200 of the combined income of B Ltd and B2 Ltd). At the same time, the Owner's basis in B2 Ltd would be increased by $200 to $1,200. This ensures that if the taxable income in B2 Ltd is distributed ($200 gross of tax, after the grouping with B Ltd) and B2 Ltd is then sold for $1,200, the Owner will have no further tax to pay. If this was not done, then the benefit of the loss-offset for B2 Ltd would be clawed back as a capital gain when the Owner sold its shares in B2 Ltd.

31. Where a loss is entirely transferred by way of subvention payment there is no need for a basis adjustment. This is illustrated below.

[6] Section DB 24 disallows a loss on sale of shares to someone who holds the shares on revenue account to the extent that a company has offset a loss to another group company.

Example four: (all taxes assumed to be 33%)



32. Receipt of the subvention payment eliminates the loss on sale of B Ltd (because it increases B Ltd's assets by $200), and thus eliminates the double use of the losses.

33. We also understand that it is common in corporate groups for the tax position of each member of the group to be equalised for any loss offsets made between group members to ensure their current tax liability on the balance sheet reflects the actual amount owing to or from Inland Revenue. This equalisation will involve a payment of the tax effect of any loss that has been offset. For a $100 loss a payment of $28 will be made between group companies.

34. To the extent this is done a portion of the double deduction of the loss is eliminated but it will not eliminate it fully.

3.2 Other jurisdictions

Australia

35. Australia does not allow tax loss integration outside of a consolidated group and ignores the shares of companies in the consolidated group completely. When a consolidated group is formed, the cost base of the subsidiary shares are pushed down to the assets of the companies, and the separate legal entity status of the companies is then ignored.

36. Loss grouping is effected by calculating the taxable income of the group as if it were a single entity. When shares of a company are sold, they have a reconstituted cost base determined by pushing up the cost base of the assets.

37. This Australian option is not suitable for New Zealand unless New Zealand adopts the same kind of corporate consolidation rules as Australia.

Japan

38. Japan addresses double tax and double tax benefit of selling shares in a subsidiary consolidated group member by making an adjustment to the cost of the shares for the change in retained earnings at the time the shares are sold. This is similar to what is being proposed in New Zealand, except we propose that an adjustment would arise when the loss offset is made.

United States

39. The United States requires comprehensive adjustments to the cost base of shares of consolidated group members called investment adjustments. In general, the basis of the shares is increased by taxable and non-taxable income and reduced by tax losses and non-deductible (but not capital) expenses. This includes reducing the basis by non-deductible income taxes paid or accrued. It is also increased by capital contributions and reduced by dividends paid. Adjustments must be tracked through a chain of companies. Negative adjustments in excess of cost base are treated as income when shares of the subsidiary are sold.

40. There are other regulations which reallocate the cost basis of shares in subsidiaries among different shareholders within the consolidated group when they are sold for a loss in order to prevent more than one deduction for a single economic loss.

41. These jurisdictions show that New Zealand would be consistent in requiring cost base adjustments in these circumstances.

3.3 Recommendation

42. Officials recommend the Group deal with the issue of double deductions as between companies and non-corporate shareholders (similar rules will apply between companies and corporate owners) as follows:

    - When a company offsets a loss to another company, the shareholders' basis in their shares is reduced by the amount of the loss less any compensation received.
    - When a company receives a loss offset from another company, the shareholders' basis in their shares is increased by the amount of the surrender less any compensation paid.

4. Unrealised gains and double taxation

4.1 Context

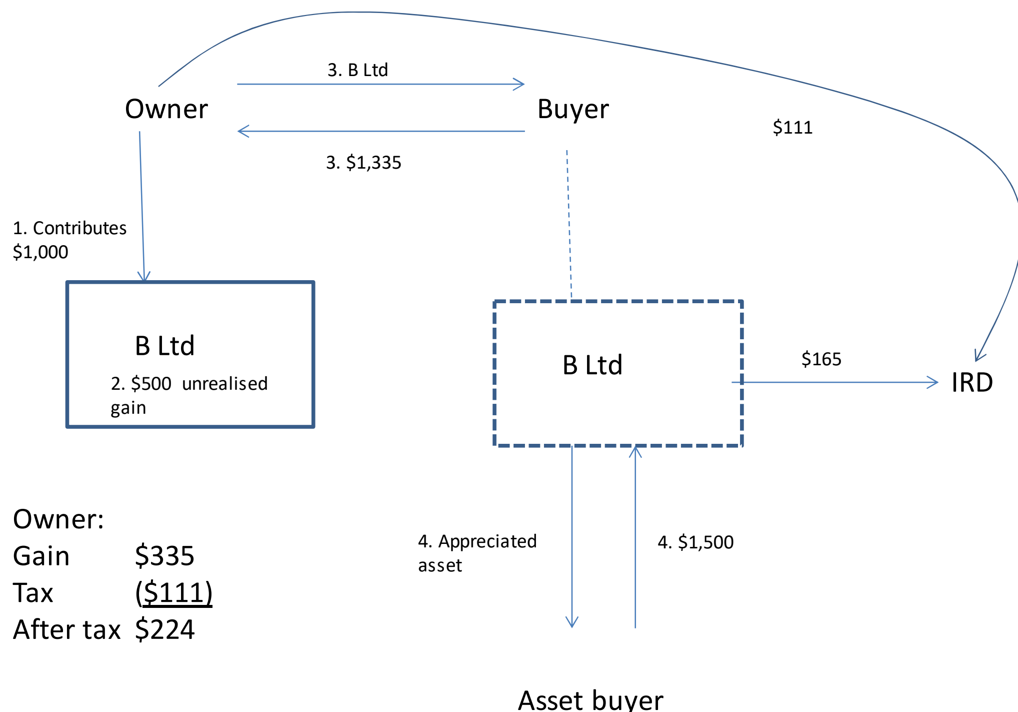
43. Similar to double taxation and double deduction issues for realised gains, an issue arises under a tax on capital gains when a company is sold holding assets with unrealised gains or losses. In this case the unrealised gain or loss is contained in an asset that will be subject to tax in the future, but the sale of shares in the company means the gain or loss is realised at the shareholder level before it is realised at the company level.

44. This gives the potential for the taxable gain or loss to be replicated when the underlying asset is disposed of by the company post-sale of the shares.

4.2 Policy problem or opportunity

45. Double taxation can arise where the company that is sold has underlying assets with unrealised capital gains or losses.

Example five: (all taxes assumed to be 33%)



46. B Ltd holds an asset with a $500 unrealised gain. The company is sold for a price that recognises this gain and the associated tax liability. The price will be no less than $1,335. The asset is then sold by the company.

47. The transaction gives rise to tax of $276 ($111 is taxed to the owner on the sale of the shares[7] and $165 to B Ltd on the sale of the asset[8]) on only $500 of economic income. $335 of the $500 gain is taxed twice.

48. The double taxation can be recovered if the Buyer liquidates B Ltd as this will crystallise a tax loss on the sale of the shares. The buyer will have a fully imputed dividend of $500 (gross) and a loss of $335. The loss arises because:

    - a liquidation of a company is treated in the same way as a sale; and
    - an amount that is treated as a dividend is not also treated as proceeds of sale (see section CD 53, though this is subject to section FA 3).

    The loss of $335 gives rise to a net tax benefit for the Buyer of $111.

49. There are two possible approaches to this outcome. The first is to do nothing. In the majority of cases where a buyer acquires a company it does so because it wants to hold the assets for a period of time, not because it wants to immediately sell them. That means the double tax impact will be reduced by the deferral of the tax impost on the unrealised gain.

50. If the buyer does want to immediately sell the assets, it can always offer to acquire the assets directly, and even if it does not, a sale followed by an immediate liquidation of the company will give the correct outcome, assuming the buyer can use the tax loss generated by the liquidation.

51. A second option would be to allow the owner and buyer to elect to treat the sale as an asset sale rather than a sale of shares.[9] In the above example:

    - B Ltd would be treated as having distributed all of its assets to the owner for their tax book value – this would mean there would be no gain in the company, and the owner would be treated as having a cost basis in the assets of $1,000, (i.e., the same basis as B Ltd – but note that it is quite possible that the Owner's basis in its B Ltd shares would not match B Ltd's basis in its assets – the Owner would need to recognise a gain (if the former were greater) or loss (if vice versa) in that case).
    - The Owner would be treated as selling the assets to the purchaser for the transaction value (now $1,500 to reflect no tax impost on the sale of the asset) which will give rise to a gain to the Owner of $500 which is equal to the difference between the transaction value and the Owner's cost in the assets ($1,000). The owner will pay tax of $165.

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[7] Calculated as ($1,335-$1,000)x33% = $111

[8] Calculated as $500x33% = $165

[9] This option gets to the same result, but the first option differs in that the sale of the shares by the owner is treated as a sale of the shares and then the purchaser uplifts the cost base of the assets to apportion the purchase price within B Ltd. This would be similar to the fair value exercise that would potentially be done for accounting purposes in any case where the purchase price is applied across all the assets purchased.

- The Buyer would then be treated as contributing the assets to the company for their transaction value, so no gain arises to the Buyer.
- This will leave the Buyer with a cost base in the shares of $1,500 and B Ltd the same cost base in the asset. When B Ltd ultimately sells that asset for $1,500 no gain will arise.
- The total unrealised gain has been subject to one level of tax in the hands of the Owner ($165).

52. Where a sellers cost base in their shares are less than the cost base of the assets it may be necessary to use a "lower of" test to ensure the correct gain is recognised that matches the step-up in asset value to the purchaser. Officials are continuing to work on the detail of that issue, however, the principle of an asset reconstruction should avoid the double taxation issue.

53. A sub-option is to allow the company to increase the basis in its assets, as if the sale had been an asset sale at the price agreed to for the shares. This could be limited to situations where there is a sale of 100% of the shares in a company.

54. Officials would need to develop these rules to make sure they work appropriately in consultation with taxpayers.

4.3 Recommendation

55. Given that the double taxation issue is able to be dealt with by liquidating the company once the asset is sold and in most situations the purchaser will want to acquire the underlying asset for a long-term purpose which will reduce the impact of the double taxation over time, officials are of the view that no response is required for this scenario. However, if the Group does want to address this issue the Government could consider the appropriateness of rules such as described above in consultation with the private sector.

56. This treatment should not be compulsory, since in some transactions, purchasers and vendors would prefer not to go to the trouble of revaluing the assets in the company for tax purposes.

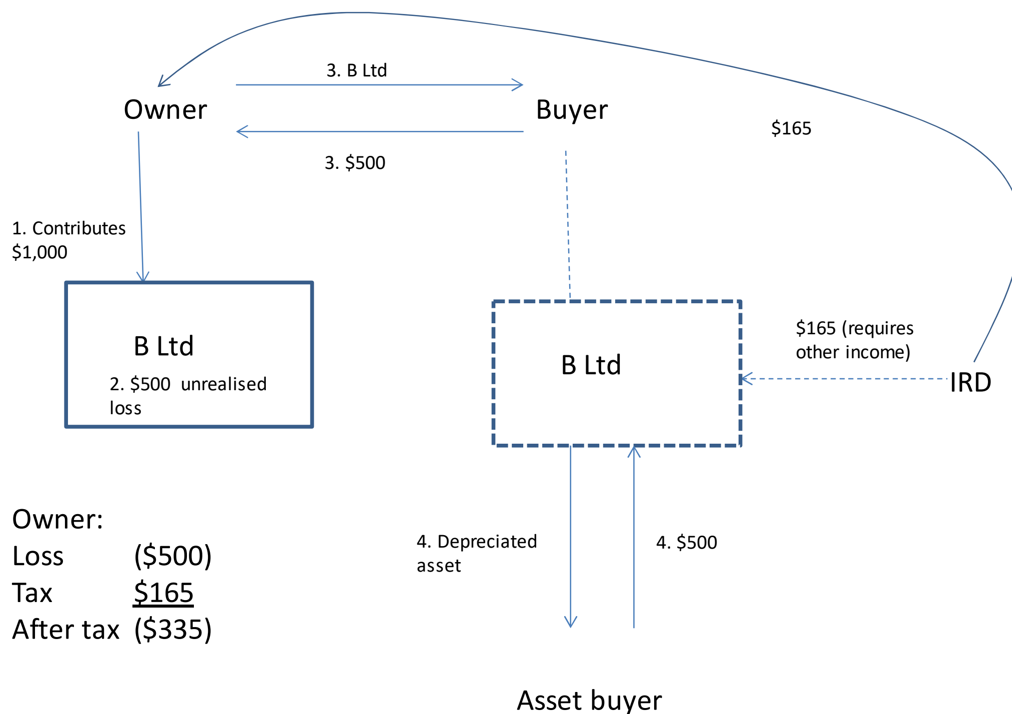
5. Unrealised losses and double deductions

5.1 Context

57. Mirror issues apply for companies with unrealised losses which, without intervention could result in the double deduction of that loss.

5.2 Policy problem or opportunity

Example six: (all tax rates assumed to be 33%)



58. In example six B Ltd holds an asset with a $500 unrealised loss. B Ltd is sold for a price that recognises this loss, but the buyer gives the owner no credit for the tax benefit of the built-in loss.

59. The outcome is appropriate for the Owner, but if B Ltd is able to recognise and use the loss after sale, there are two deductions for a single loss. This benefit will be recaptured if the income of B Ltd, sheltered by the loss, is distributed to the buyer, or if the buyer sells its shares in B Ltd and the loss is eliminated by the change of ownership.

60. If the owner can extract full value for the loss, the owner will sell the company for $665, giving a loss of $335 and a smaller immediate tax benefit of $111. A subsequent sale of the asset by B Ltd for $500 will still mean there is an aggregate tax loss of $885, when the economic loss is only $500.

61. This issue could be addressed by reducing B Ltd's cost basis in its assets to reflect the reduced consideration paid for its shares. This would have to be a mandatory provision. It would only be triggered by a significant change of ownership in the company, say more than 50%. In the case of a sale of less than 100% of the company, it would mean that the continuing shareholders were somewhat disadvantaged, because a sale of the asset for $500 would not give rise to a tax loss for B Ltd. However, because there is no adjustment to the cost base of the continuing shareholders, on a sale of their shares or a liquidation of B Ltd, they will be able to claim a deduction for the loss.

62. This option also reflects the principle that a person who incurs a loss should be the person who uses the loss, which is the foundation for the current continuity of loss provisions.

5.3 Other jurisdictions

63. The Australians deal with this issue by capping the amount of loss a company can claim to the amount that accrued after the purchase of the company. That will apply if the company fails the Australian same business test for loss continuity after the sale.

64. If the entity maintains the same business then it is able to use any loss, however, if it doesn't then its loss is limited to that accrued after the purchase of the company.[10]

5.4 Recommendation

65. Officials recommend the Group recommend a rule to deem the sale of shares in a company to be the sale of the underlying assets on a compulsory basis where the company sold has assets with total net tax bases that are substantially higher than the sale price of the shares. For example, an option could be that where more than 50% of a company is sold for an amount that is less than 80% of the net tax value of the company's assets, the basis of the company's assets is reduced to reflect the sale price.

[10] Our recommendation would appear to be a harsher treatment than the Australian model, however, it reflects our overall framework on loss continuity where the person who incurs the loss should be the person who uses the loss.

6. Distribution of untaxed gains made prior to taxing more capital gains

6.1 Context

66. There are rules in the Income Tax Act which treat amounts distributed on the winding up of a company as being first a return of available subscribed capital (ASC), second a distribution of net capital gains and lastly a dividend. There is also a rule which provides that amounts which are taxable as dividends are not also taxable as sale proceeds.

67. In its *Interim Report* the Group considered that under an expanded tax of capital gains these rules would not need to change. However, it did want to further consider the rules distinguishing between returns of capital, distributions of capital gain and dividends.

68. This distinction will be particularly important for non-resident shareholders who may face different levels of tax on dividends and capital gains than resident shareholders.

69. The clear policy intention is that realised and unrealised capital gains that arose before the implementation date of the new rules would remain able to be distributed on a liquidation free of tax.

6.2 Policy problem or opportunity

70. An amount paid to a shareholder on the liquidation of a company will not be taxable to that shareholder to the extent that it includes the available subscribed capital per share and the available capital distribution amount.

Example seven:

71. Waterview Properties Limited (WPL) is a property-owning company which has sold its only asset prior to the extension of tax on capital gains making a capital profit of $300m. Its balance sheet is as follows:

	$m		$m
Cash	$700	Capital	$300
		Capital gains	$300
		Retained earnings	$100
	$700		$700

72. On liquidation of the company the amount that could be returned to shareholders tax free will be:
    - the ASC per share which assuming there are 300m shares would be $1; and
    - the capital gain amount of $1 per share.

73. The remaining 33 cents per share (i.e., 100/300) would be taxed as a dividend but should have sufficient imputation credits available to be attached to the dividend.

74. Under an extension of capital gains tax there is no reason why this rule should alter but a delineation will need to be made between capital gains made prior to the extension of taxation of capital gains and those made after that extension. In a practical sense, this delineation may arise automatically, by virtue of the fact that the gains made after the extension occurs are taxable.

Example eight:

75. Cityscape Properties Limited (CPL) is a property-owning company which has 300m $1 shares on issue, which it used to acquire a high rise building for $300m, some years before the extension of tax on capital gains. On the "valuation date" the property was valued at $400m. Three years later CPL sells the building making a capital profit of $300m. The taxable gain on the sale of the building will be $200m, (calculated as the sale price of $600m less the median of the sale price $600m, the market valuation $400m and the cost price $300m. Its tax balance sheet after the sale is as follows (assuming a tax rate of 28%):

	$m		$m
Cash	$544	Capital	$300
		Capital gains	$100
		Retained earnings	$144m (plus $56m ICs)
	$544		$544

76. From a policy perspective the amounts that should be available to return to shareholders tax-free from a liquidation of CPL are the ASC amount of $300m and the $100m gain that arose prior to the introduction of an extension of taxation of capital gains. The remaining $144m should be taxable as a dividend.

77. This result should flow from the transitional provisions for introduction of a tax on capital gain:

- For CPL, those rules should split the $300m of profit on sale of the building into $100m of tax free capital gain prior to the introduction of the new tax and $200m of taxable capital gain. The $100m should continue to be available for distribution free of tax.
- For the CPL shareholders, the $144m should be treated as a taxable dividend of $200m inclusive of a $56m tax credit. The remaining $400m will be treated as sale proceeds. Shareholders who acquired their shares before the introduction of the tax will have a cost base equal to the median of their actual cost, the valuation day value of $1.25 per share, and the sale price of $1.25 per share. Whatever their actual cost, the median will be $1.25 per share, so there will be no additional gain or loss for the shareholder. A shareholder who acquires their shares after the introduction will have a taxable gain or loss equal to $1.25 less their cost base.

6.3 Loss on liquidation

78. A liquidation also raises a question as to how a loss on liquidation should be treated and who would be permitted to claim that loss. If on liquidation a company made a loss that loss would be extinguished by the winding up of the company, but someone should have access to that loss.

79. On liquidation the shareholder will have a disposal of their shares for the consideration received from the liquidation less any dividend. The resulting calculation should effectively transfer that loss on liquidation to the shareholder.

Example nine:

80. Farm-to-gate Properties Limited (FPL) is a property-owning company owned 50% each by Ben and Kelvin. It has purchased and sold its only asset after the extension of tax on capital gains. FPL purchased the property for $20m but some years later decides to get out of the property market. It sells the property for $15m and liquidates the company. Its “tax” balance sheet prior to liquidation is as follows:

	$m		$m
Cash	$15	Capital	$20
		Capital Loss	$(5)
		Retained Earnings	0
	$15		$15

81. For FPL, on the sale of the building, it will calculate its capital loss as $5m, calculated as the sale price $15m less the cost price of the building $20m. This capital loss will be forfeited when FPL is liquidated.

82. On liquidation, the amounts returned to FPL’s shareholders Ben and Kelvin is $15m which is a return of ASC. This receipt will be considered sale proceeds for their investment in FPL and therefore when their shares are cancelled, they will calculate a loss on sale of $5m (again being, $15m proceeds less cost of $20m). This will result in the loss on the property effectively being claimed by the shareholders. In addition, the loss is claimed only once.

83. Note that if FPL grouped its $5m loss on sale of its property with another company, the shareholders’ basis in their shares would be reduced to $15m, and there would be no loss on the liquidation.

84. This should also be the case for property acquired prior to any extension of capital gains tax.

Example ten:

85. Moxham Limited is a property-owning company, owned 50% each by Jason and Kim. It has acquired its only asset prior to the extension of tax on capital gains for $70m. At valuation date the market value of the property is $55m. It decides to sell the asset subsequent to the extension of capital gains for $40m. After selling the asset it liquidates the company. Its tax balance sheet prior to liquidation is as follows:

	$m		$m
Cash	$40	Capital	$70
		Capital loss	$(30)
		Retained earnings	0
	$40		$40

86. The calculation of the loss on sale for Moxham Limited results in a deductible loss of $15 being the sale price of $40 less the market valuation of $55 (the median of the cost price, $70, market value, $55, and sale price, $40). This will split total loss between pre and post capital gain amounts (i.e., $15 and $15 respectively).

87. On liquidation the capital loss within the company will be forfeited and the shareholders, Jason and Kim, will receive $40m on liquidation of the company. That will be able to be paid tax-free as a return of share capital.

88. Jason and Kim will then calculate tax on the disposal of their shares. They will calculate a capital loss of $15 being the amount received on liquidation of $40 less $55 (i.e., the median of cost, $70m, market value, $55m and sale proceeds, $40m). Again, the median rule will split out the loss that arose before and after the introduction of an extension of the taxation of capital gains and the correct result should be calculated.

89. Other than minor amendments to limit the amount of capital gains that can be distributed on liquidation to "pre-application of tax on capital gains" amounts we do not consider any special rules are required to deal with liquidations after any extension of tax on capital gains.

6.4 Recommendation

90. Other than minor amendments to limit the amount of capital gains that can be distributed on liquidation to gains that arose prior to the introduction of the extension of the taxation of capital gains we do not consider any special rules are required to deal with liquidations after any extension of tax on capital gains.

7. Qualifying companies

7.1 Context

91. The qualifying company (QC) regime was replaced by the look through company (LTC) regime from 1 April 2011. From that date on, no new qualifying companies could be formed, but existing QCs were allowed to continue.

92. The QC regime was aimed at companies which had five or fewer natural person shareholders and has two benefits:

    - shareholders can sell out of the business by selling the shares rather than selling assets and crystallising tax liabilities (useful pre-the extension of the taxation of capital gains); and
    - capital gains[11] can be passed out to shareholders tax free without needing to liquidate the company.

93. Under the QC regime:
    - The company calculates its income and pays tax at the 28% rate. The income is not treated as earned by shareholders until distributed.
    - Capital gains and reserves (realised and unrealised) can be passed tax-free to shareholders without having to wind up the company.
    - Shareholders are liable for the tax on income derived by the company (if the company fails to pay).
    - Non-cash dividends other than a taxable bonus issue are exempt in the hands of the shareholders as are cash dividends to the extent they are not imputed.
    - Sale of shares in a QC is treated as a sale of shares, rather than a sale of the underlying assets.

94. The purpose of the regime is similar to the LTC regime in that it is intended to remove the drawbacks of corporate taxation. The LTC regime is more principled in that it treats the shareholders and the company like a partnership. The QC regime is a hybrid, being more a corporate tax regime with a modification for capital gain distributions.

95. When more capital gains are taxed it is questionable as to whether the QC regime should be retained. There are currently around 61,000 QCs still in existence, of those 50,000 are continuing to file returns.

7.2 Policy problem or opportunity

96. Under a more comprehensive taxation of capital gains the main reason for having a QC is removed. As all capital gains will be subject to tax there is no need for the

[11] Capital gains in this context refers only to capital gains made on the sale of property it does not include other non-taxed income such as dividends on foreign shares in excess of the FDR rate.

ability to pass through capital gains tax-free to shareholders of QCs as they will be taxable in any case and should carry imputation credits.

97. This is true for the earnings of a QC post the extension of tax on capital gains. However, for those retained earnings of a QC at the time of introduction where these comprise capital gains this should continue to be available to be passed through to shareholders of a QC tax free (as is proposed for normal companies which liquidate).

7.3 Options

98. There are two possible options for the QC regime after the introduction of an extension to the taxation of capital gains. The first is to retain the QC regime and the second is to remove the regime and allow QCs to transition to normal companies or become LTCs.

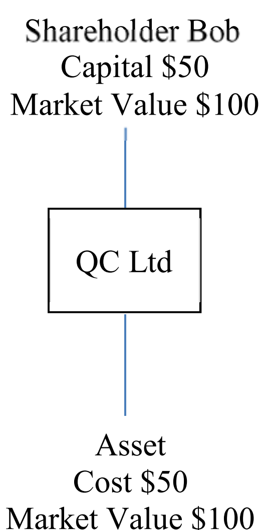
99. Either way, it seems appropriate to allow QCs or ex-QCs, to distribute pre-valuation day capital gains, both realised and unrealised, free of tax.

Retain the QC regime

100. The consequence of retaining the QC regime would be to ensure that any realised and unrealised capital gains up to the date of any extension of taxing capital gains are preserved and able to be distributed to shareholders tax-free while ensuring that no additional benefit can be obtained through the operation of a capital gains tax on the sale of the investment itself.

101. This should be achievable by:
- applying the median rule at the level of the shareholder and the company; and
- reducing both the cost price and valuation date value by the amount of any unimputed distributions.

Example eleven:



102. In example eleven QC Limited owns an asset that is worth $50 but has a market valuation of $100 on valuation day. If the QC status was preserved after that date Shareholder Bob should be able to pay out $50 as a capital gain amount tax-free.

103. Suppose QC Limited sells that asset after the introduction of a tax on capital gains for $100 and that the median rule would deem the cost base of that asset to be $100 (i.e., the median of market value, $100, sale price, $100 and cost $50). No capital gain will arise in the company as intended as that capital gain was related to a period prior to the extension of tax on capital gains.

104. If that $50 profit is distributed, Shareholder Bob will not be taxed on the distribution as it is not imputed as no tax was payable by QC Limited on the sale of the asset.

105. Suppose that after distribution of this profit, Shareholder Bob still has a cost base for his shares of $50. Assuming he is able to sell the shares in the company for $50 being the cash retained in the company after the sale of the asset and distribution of this profit he will make a capital loss on the sale of the shares of $50 which he potentially can offset against other income (ignoring the median rule[12]). This is not appropriate as Shareholder Bob has not suffered any economic loss.

106. If the QC regime were retained, it would be necessary to eliminate the tax loss by adjusting the cost base and valuation day of Shareholder Bob's investment in QC Limited by the amount of the unimputed distribution from QC Limited after the valuation day (and adjusting the cost base (but not the valuation day value) for unimputed distributions before the valuation day). In this case, that would reduce Shareholder Bob's cost base in his QC Ltd shares to $0 and his valuation day value to $50. This means no gain or loss would arise on a sale of his shares for $50, which is the correct outcome.

Example twelve:

107. Assume the same facts as in the example eleven but assume that QC Limited sells the asset for $80 after the introduction of the tax, having already distributed $50 tax free. Shareholder Bob now sells his shares for $30. Again, in QC Limited the proposed median rule would leave no taxable gain or loss as the cost base would now be $80 (i.e., the median of market value $100, sale price $80 and cost $50).

108. Assume as before that the $50 distribution reduces Shareholder Bob's cost base in his shares to $0 and valuation day value to $50. This means the sale of the shares gives rise to no gain or loss, since the median rule gives a deduction of $30 against the sale price of $30. The overall outcome is no gain or loss. This appropriately reflects the policy of the median rule, where an asset produces a paper loss post-introduction of CGT, but a real gain.

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[12] If you consider the application of the median rule in this circumstance that should result in the correct gain or loss being subject to tax. In this example Shareholder Bob will be subject to tax on the difference between the sale price $50 and the sale price $50 (being the median of market value $100, sale price $50 and cost $50). However, an adjustment will still be required in case the market value amount is ever the median.

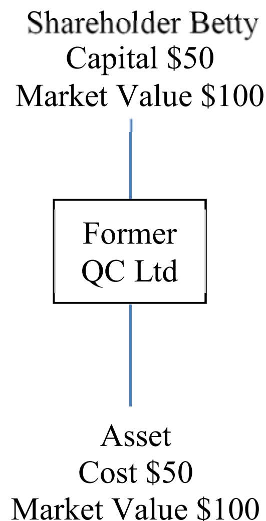
Transition to normal company or LTC

109. The alternative option would be to repeal the QC regime and require QCs to transition to a normal company structure or an LTC. Transitional rules may be required for some of the procedural issues that arise with a transfer to an LTC and these were used when the entry to the QC regime was closed.[13]

110. An issue arises for those QCs which hold assets with unrealised gains on the transition. An extension of tax on capital gains will ensure that at the company level (or the shareholder level for an LTC[14]) no gain or loss will result on capital gains arising prior to the extension of tax on capital gains.

111. However, under the QC regime those amounts would have been able to be passed to shareholders tax-free. In a normal company structure that tax-free distribution will only be available on liquidation.

Example thirteen:



112. Former QC Limited (FQC) was a QC up until the regime was repealed on the extension of tax on capital gains. Shareholder Betty decided to transition FQC to a normal company rather than an LTC.

113. On the date of transition FQC held an asset which had a cost of $50 but a market value on valuation date of $100. Three years after the transition FQC sells the asset for $120. Under the median rule FQC calculates its capital gain on the sale of the asset as $20 being the difference between the sale price and the market value of $100 (i.e., the median of the sale price $120, market value $100 and cost price $50). That

[13] These transitional provisions provided for the LTC to adopt the taxation profile of the QC and permitted any loss balance to be available for offset against future income of the new entity.

[14] The reason any gain or loss is assessed at the shareholder level under an LTC is that it is a transparent entity and tax is assessed to the shareholders directly at their marginal rates.

gives the correct answer as the asset has increased by $20 since the extension of tax on capital gains. FQC pays $5.60 in tax.

114. When FQC distributes the gains that arose both before and after the introduction of an extension of the taxation of capital gains to Shareholder Betty it will only have $5.60 of imputation credits to attach to the distribution and Shareholder Betty will have to pay tax on the entire gain of $70 (i.e., $120-$50).

115. If FQC was still a QC, $50 of that amount would be exempt in the hands of Shareholder Betty and she would only be taxable on the portion that was fully imputed (i.e., $20). As a normal company, FQC will only be able to distribute the $50 of funds to Shareholder Betty tax-free on liquidation.

116. If it were thought desirable to allow a QC that converts to ordinary company tax treatment to continue to be able to make non-liquidating distributions of capital gain on a tax-free basis, it might be possible to increase the available subscribed capital (ASC) of the company by any unrealised gains in the company at valuation date. That would give FQC $50 of ASC which it could cancel to fund a tax-free distribution to Shareholder Betty. This would enable the equivalent treatment as if the company was still a QC. However, tax-free treatment would require FQC to cancel shares, and the cancellation to meet the brightline requirements for a return of capital.

117. Now assume that instead of selling the asset for $120 FQC actually sold it for $80. If FQC has been permitted to increase its ASC by the original market valuation of $50 this would mean it could shelter an additional $20 of income which it should not be able to do.

118. A further rule would be required, similar to the rule required under the option of retaining QCs so that, where the realised gain was less than the gain calculated under the market valuation, a reduction in ASC would be required. In this case FQC's ASC would be reduced by $20 (i.e., the difference between the market valuation and the sale price). This would ensure that only the actual gain from the asset could be distributed tax-free.

119. Moving to Shareholder Betty's tax position, if FQC liquidates and distributes $80 to her other than as a dividend, that should give rise to no gain or loss as her cost base will be $80 (i.e., the median of cost $50, sale proceeds of $80 and valuation day value of $100).

120. This issue does not arise for the transition to an LTC as distributions from an LTC are ignored. Because the gains that arise before the introduction of an extension of the taxation of capital gains are preserved generally through the median rule no gain or loss will result to the shareholders' tax calculations.

7.4 Recommendation

121. With appropriate valuation day and cost basis adjustment rules, it would be possible for the existing QC regime to continue to operate in the presence of a general

tax on capital gains. However, given the main reason for the retention of the QC regime would disappear after the extension of tax on capital gains it would seem appropriate to consider repealing that regime and requiring QCs to transition to an ordinary company or an LTC regime.

122. Procedural transitional rules will be required to allow transition to an LTC, however, to a large extent these can be duplicated from the provisions that were used when LTCs were introduced.

123. A number of adjustments will be required for those who transition from a QC to the standard company tax treatment if it is thought desirable to permit the continuing company to retain the ability to make non-liquidating distributions of pre-valuation day capital gains. This could be done by way of adjustments to the company's ASC. These adjustments would need to be reversed to the extent that a capital asset is sold for less than its valuation day value.

5. Conclusion and recommendations

124. Officials recommend that the Group considers the following rules for dealing with these issues for inclusion in the *Final Report*:

- Relax the imputation continuity rules to remove the possibility of the double taxation of realised gains. These rules should be amended using the Australian model as a guide which will allow imputation balances to survive a change in ownership but quarantine those credits that arose whilst the entity was owned by non-residents or a tax-exempt entity.
- Reinforce the recommendation outlined in the *Interim Report* for adjustments to the share basis of shareholders investments where losses are offset within a corporate group.
- Introduce rules to deem a liquidation and disposal of the assets when a share sale is undertaken which will eliminate any double taxation or deduction of those gains or losses. These rules should be optional for unrealised gains and compulsory for unrealised losses when there was the sale of at least 50% of shareholding for an amount less than 80% of the net asset value for tax purposes.
- Amend the definitions of capital gain amounts that can be distributed tax-free on liquidation to only allow capital gains arising prior to any extension of tax on capital gains to be passed to shareholders tax-free.
- Remove the qualifying company regime and existing qualifying companies be permitted to transition to normal or look through companies.

Appendix A: Suggested text for final report

Domestic share issues with taxing more capital gains

1. The *Interim Report* expressed the view that in many cases, double taxation issues are able to be managed without the need for legislative change. However, it identified the following issues as requiring further consideration:
   - The appropriateness of the current rule which eliminate imputation credits on a change of ownership of more than 34% in a company (paragraph 155).
   - How best to prevent realised losses in a company giving rise to a double deduction on sale of the company (paragraph 161).
   - Whether double taxation arising on a sale of shares in a company with appreciated assets should be dealt with by allowing the parties to treat the transaction as a sale of assets for tax purposes (paragraphs 158-159).
   - What rule would be appropriate to prevent unrealised losses in a company giving rise to a double deduction (paragraph 163).
   - What rules might be necessary to ensure that capital gains arising before the valuation date remain able to be distributed by a company on a tax-free basis (paragraph 172).
   - The repeal of the qualifying company regime (paragraph 171).

2. The Group has considered these issues further. Its analysis and recommendations follow.

Double taxation of realised gains – imputation credit continuity

3. Taxing capital gains on the sale of shares raises a risk of double taxation on the company income if company income is not distributed prior to sale.

4. The scope of this problem seems limited:
   - Data shows that public companies tend not to accumulate imputation credits, so for those companies, there is little accumulation of taxed company income that is potentially subject to double tax.
   - While private, closely held companies do accumulate imputation credits they have the ability to remove double taxation before a sale of company shares by paying an imputed dividend or making a taxable bonus issue.
   - If double taxation is not prevented by a pre-sale dividend or taxable bonus issue it is reversed once the company distributes the earnings to the purchaser with imputation credits attached. However, the current rules around imputation credit continuity will prevent the reversal where there is a change in the ownership of the company of greater than 34%.

5. The purpose of the imputation credit continuity rule is to prevent the inappropriate transfer of tax benefits to those with a tax rate that is lower than the owner of the company at the time the credits were generated.

6. If all share gains become taxable, this rationale for the imputation continuity rule largely disappears. A shareholder cannot escape tax at its marginal rate on the company's retained earnings by selling its shares. However, if the shareholder is not taxable on the sale by virtue of being tax exempt or non-resident:
    - there are no double taxation issues, since the shareholder is not taxable on the sale of the retained earnings; and
    - a transfer of the company to shareholders on a rate below 28% would not be appropriate.

7. The Group considers that the current imputation credit continuity rules can be relaxed after any extension of tax to domestic share sales. We consider that the Australian model of quarantining credits that arose during the ownership of the company by non-residents or tax-exempt entities is a more appropriate form of imputation continuity.

8. The Group believes that this measure will deal with those double tax issues that are not otherwise dealt with in relation to gains realised before the sale of shares.

Double deduction of realised losses

9. As noted in the *Interim Report,* the Group was of the view that in most cases the possibility of a double deduction for realised losses was limited due to the loss continuity rules.

10. The Group noted that the one case where this would not apply is when the loss of a company is offset within a corporate group other than by way of subvention payment.

11. In the *Interim Report*[15] the Group recommended that cost base adjustments to the shares in both the company offsetting and receiving the loss be adjusted to ensure that deductions are not able to be claimed twice.

12. The Group confirms its view that this should deal with any double deduction issues that may arise in relation to realised losses.

13. The Group also notes that the extension of tax to share gains and losses should reduce any pressure to change the current rule eliminating losses in a company on a 51% change of ownership.

Unrealised gains

14. Double taxation can arise when a company which has unrealised gains relating to its assets is sold. It is possible that these gains can be realised once through the sale of shares as the purchase price reflects those gains and once when the assets are sold by the company.

15. There are two possible approaches to dealing with this issue. The first is to do nothing. In general, when someone purchases a company with assets it will want to

[15] See part XVI of the Interim Report

hold those assets for a period of time. They will not generally want to immediately dispose of those assets. The passage of time will reduce the issue of double taxation.

16. A second option would be to deem the sale of shares to be the sale of the underlying assets of the company. This option would:
    - Deem the company as having distributed all of its assets to the owner for their tax book value – this would mean there would be no gain in the company, and the owner would be treated as having a basis in the assets of the same as the company – in any case where the owner's basis in its shares did not match the company's basis in its assets the owner would need to recognise a gain (if the former were greater) or loss (if vice versa).
    - Treat the owner as selling the assets to the purchaser for the transaction value which will give rise to a gain to the owner of the unrealised gain on the assets which is equal to the difference between the transaction value and the owner's cost in the assets.
    - Treat the buyer as contributing the assets to the company for their transaction value, so no gain arises to the buyer.
    - Leave the buyer with a cost base in the shares of the transaction value and B Limited the same cost base in the asset so when it ultimately sells that asset no gain will arise.

17. As this option would require the valuation of the assets, and the double taxation issue is likely to only be an issue if the purchaser wants to dispose of the assets in the short term, we recommend that this process be optional in relation to unrealised gains.

Unrealised losses

18. Mirror issues apply for companies with unrealised losses which, without intervention, could result in the double deduction of that loss.

19. In most cases these issues will result in minor issues when small amounts of shares are traded, however, the Group has a concern when a large proportion of the shares are disposed of. This could result in some large avoidance opportunities which is undesirable.

20. These issues could be addressed using the same mechanism that we have recommended above in paragraph 16 for unrealised gains, however, in respect of unrealised losses this would be compulsory.

21. As the concern in this area is for major changes in shareholding, we would recommend limiting the application of that rule to share sales of 50% or more of the company where the company is sold for a sale price that reflects a valuation of the company at less than 80% of the net tax value of its business.

Distribution of pre-tax gains

22. The Income Tax Act treats amounts distributed on the winding up of a company as being first a return of available subscribed capital (ASC), second a distribution of net

capital gains and lastly a dividend. There is also a rule which provides that amounts which are taxable as dividends are not also taxable as sale proceeds.

23. In its *Interim Report* the Group considered that under an extended tax on capital gains these rules would not need to change, however, it did want to further consider the rules distinguishing between returns of capital, distributions of capital gain and dividends.

24. The clear policy intention of the rules should be to allow the ASC of a company and any capital gains that relate to a period up until the extension of tax to more capital gains to continue to be passed to shareholders tax-free.

25. After consideration the Group does not believe any special rules are required to deal with this issue. However, some modifications may be required to ensure:
    - only capital gains made prior to the extension of tax on capital gains are passed to shareholders tax-free on a liquidation; and
    - any funds or assets received by shareholders on liquidation are consideration for the disposal of those shares, to the extent that they are not dividends.

Qualifying companies

26. The qualifying company regime was replaced by the look through company (LTC) regime from 1 April 2011, however, existing qualifying companies (QC) continue to operate under the regime.

27. The QC regime was aimed at companies which had five or fewer natural person shareholders and has two benefits:

    - Shareholders can sell out of the business by selling the shares rather than selling assets and crystallising tax labilities (pre-dating the extension of capital gains tax); and
    - Capital gains can be passed out to shareholders tax free without liquidating the company.

28. If more capital gains are taxed it is questionable as to whether the QC regime should be retained. We understand that there are currently around 61,000 QCs still in existence.

29. Under a more comprehensive taxation of capital gains the main reason for having a QC is removed. As all capital gains will be subject to tax there is no need for the ability to pass through capital gains tax-free to shareholders of QCs as they will be taxable in any case and should carry imputation credits.

30. This is true for the earnings of a QC after the extension of tax on capital gains. However, for those retained earnings of a QC at the time of introduction where these comprise capital gains this should continue to be available to be passed through to shareholders of a QC tax-free (as is proposed for normal companies which liquidate).

31. There are two possible options for the QC regime if more capital gains are taxed. The first is to retain the QC regime and the second is to remove the regime and allow QCs to transition to normal companies or become LTCs.

32. Either way, it is probably appropriate to allow QCs or ex-QCs, to distribute pre-valuation day capital gains, both realised and unrealised, free of tax.

Retain the QC regime

33. The consequence of retaining the QC regime would be to ensure that any realised and unrealised capital gains up to the date that any extension of taxing capital gains is applicable are preserved and able to be distributed to shareholders tax-free whilst ensuring that no additional benefit can be obtained through the operation of a capital gains tax on the sale of the investment itself.

34. This should be achievable by:
    - Applying the median rule at the level of the shareholder and the company; and
    - Reducing both the cost price and valuation date value of the shares by the amount of any unimputed distributions occurring after the shareholder acquired the shares (and after the valuation date in the case of reductions in the valuation date value).

Transition to normal company or LTC

35. The alternative is to repeal the QC regime and require QCs to transition to a normal company structure or an LTC. Transitional rules may be required for some of the procedural issues that arise with a transfer to an LTC and these were used when the entry to the QC regime was closed[16].

36. An issue arises for those QCs which hold assets with unrealised gains on the transition. An extension of tax to capital gains will ensure that at the company level (or the shareholder level for an LTC[17]) no gain or loss will result on capital gains arising prior to the extension of tax on capital gains.

37. However, under the QC regime those amounts would have been able to be passed to shareholders tax-free. In a normal company structure that tax-free distribution will only be available on liquidation.

38. This issue does not arise for the transition to an LTC as distributions from an LTC are ignored because pre-extension of tax to capital gains are preserved generally through the median rule and no gain or loss will result to the shareholders' tax calculations. However, this is an issue for QCs who transition to general companies.

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[16] These transitional provisions provided for the LTC to adopt the taxation profile of the QC and permitted any loss balance to be available for offset against future income of the new entity.

[17] The reason any gain or loss is assessed at the shareholder level under an LTC is that it is a transparent entity and tax is assessed to the shareholders directly at their marginal rates.

39. A solution to this issue would be to increase the available subscribed capital (ASC) of the company by any unrealised gains in the company at valuation date. This would enable a similar treatment to that applying if the company was still a QC, though it would require the company to cancel shares and meet the relevant bright line tests.

40. A further rule would be required in that where an asset held by a qualifying company is sold for less than is valuation day valuation, a reduction in ASC would be required to ensure that the additional (surplus) ASC could not be used to shelter other income.