



20 July 2010

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Dear David

SHAREHOLDER CONTINUITY RULES: SECTION YC 15 OF THE INCOME TAX ACT

The Society welcomes the opportunity to comment on the proposals to amend section YC 15 of the Income Tax Act 2007.

Section YC 15(1)(b)(i) - Transactions that should be entitled to concessions

First Proposed Change

The Society supports the intent of this proposed change. It is concessionary to taxpayer companies for principled reasons and will improve the clarity of the legislation. The Society agrees the current wording of sYC 15(1), and in particular the use of the phrase “was not due only to”, is ambiguous. It could cause the underlying tracing concessions in sYC 10 and sYC 11 to become functionally inapplicable for many widely held companies. However, the Society suggests a different way of setting out this clarification.

The 5% concept suggested may be difficult to apply. A company may have to first carry out detailed calculations to ascertain shareholder continuity (but for the concessions), in order to claim 5% threshold concession. A compliance concession should of course avoid the need for compliance that is not justified on a cost/benefit basis.

Wording of Proposed Change

The Society agrees with the situations identified by officials where the concessions should apply and not be limited by sYC 15. A clearer way to provide concessionary treatment would be to list suitable transactions that are not to be included in determining whether a director had actual or constructive knowledge of a breach of shareholder continuity.

The types of transactions to be included are those involving small private transactions and small off-market transactions. These so-called “safe-harboured” transactions could include the following classes:

- on market minority share sales: share sales between shareholders with interests of less than 10% in the ordinary course of trading on a recognised exchange;
- off market minority share sales: share transfers by shareholders with interests of less than 5%, being private sales in which the company itself is not a party;

- de minimus share sales: share sales in which the company is a party, provided they do not involve more than a 5% change in shareholdings in an income year;
- the cancellation of shares in a widely-held trust as described in existing paragraphs YC15(1)(b)(ii) and (iii).

Providing company directors with a clear list of transactions that are not required to be taken into account when determining whether shareholder continuity concessions apply, would provide greater certainty to these companies. The Society considers this may best be achieved by reorganising the wording of YC 15(1). The suggested rewording is as follows:

“This section applies if—

- (a) the requirements of a continuity provision would not have been met for a company at a time but for the application of section YC 10, YC 11, or both; and
- (b) the directors of a company know or could reasonably be expected to know, without making enquiries specifically for the purposes of applying the continuity provisions, that the requirements of the continuity provision would not have been met but for that concessionary application; and
- (c) the failure, but for that concessionary application, to meet the requirements would have arisen even if the following events or circumstances were disregarded:
 - (i) the sale of shares in a company in the ordinary course of trading on a recognised exchange between less than 10% interest holders:
 - (ii) the transfer of shares in a company by less than 5% holders that occur other than on a recognised exchange and to which the company is not a party:
 - (iii) the transfer of shares in a company where the director has knowledge of the transfers but which are in aggregate a change to the total shareholding in the company of 5% or less in an income year:
 - (iv) the cancellation of shares in a unit trust, that falls within paragraph (a), (b), or (c) of the definition of widely-held trust, held by less than 10% holders:
 - (v) the cancellation of shares in a unit trust, that falls within paragraph (a), (b), or (c) of the definition of widely-held trust, which were acquired from less than 10% holders by the manager or trustee of the unit trust in the ordinary course of their activities in relation to the unit trust.”

The Society also considers that the risk of the concessions being manipulated by companies is low.

For listed companies, the ability to communicate with shareholders and for share transactions to proceed without the proposal being put to all shareholders is protected by company and securities law. The ability for other companies to manipulate the rules to their advantage would be impinged significantly by the new associated persons rules, as both tracing concessions do not apply to associated companies.

Accordingly, it is appropriate to include set classes of common and minor transactions which directors should not be required to turn their minds to when a company is ascertaining its levels of shareholder continuity.

Application Date

The intent behind making the proposed change retrospective is that it may reflect existing practice and is also concessionary. However, any retrospective application of the new provision should be optional for taxpayers.

It is not possible to that conclude no taxpayer will be disadvantaged by the proposed change because the positions taxpayers have taken in the past cannot be fully anticipated. It is only fair for taxpayers to be entitled to apply the wording of the legislation that was in place at the time to past periods. Accordingly, taxpayers should be able to apply the amended wording effective from 1 April 2005, if they so choose, by not applying the amended wording. This approach would also deal with any past uncertainty of how YC 15 applied without causing any unintended disadvantage to taxpayers.

Directors' knowledge of breach***Second Proposed Change***

The Society does not generally support this proposed change for the following reasons:

- (a) Uncertainty
 - (i) Widening the extent of knowledge required of a director to include knowledge of a *likely* breach of shareholder continuity would create an unacceptable level of uncertainty. The term itself is vague and would be difficult to apply. Adding likely breaches as a lower threshold to the test would add further complexity.
 - (ii) It is difficult enough at present for directors to know when they can and cannot rely on the tracing concessions without extending this to “likely” breaches. For example, if statistics are available that show a certain level of share ownership turnover in a listed company, at what point are the directors to consider that a breach of continuity was likely and that they cannot rely on any tracing concessions?
 - (iii) The application of the law should be sufficiently certain for companies to self-assess their position. There are clear thresholds for the underlying levels of continuity required, being the 49% and 66% continuity of shareholding levels carry forward of tax losses and imputation credits, respectively. So there should also be clear evidence a director had actual or constructive knowledge of a breach before the tracing concessions are taken away. If there is increased uncertainty because directors must take into account whether they should have considered that a breach of continuity was merely *likely*, then companies will have to stay even further inside the above thresholds in order for the company to take a tax position. Again, this would defeat the purpose of the tracing concessions and having such clear tests of the continuity levels required.
- (b) Harshness of outcome

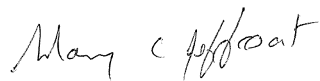
The consequences of not being able to apply the concessions are significant. Companies need to be able to determine whether or not losses or imputation credits are available and cannot be expected to have knowledge of likely breaches of shareholder continuity in situations where, as officials note, it is difficult or even impossible for directors to trace company ownership. Extending directors' knowledge requirements to include potential breaches will worsen this problem. The Society also questions whether this change, in practice, would result in situations where it is easier to prove that YC 15 should apply and the tracing concessions should be lost.

Conclusion

If the first proposed change can be worded to achieve a suitable level of certainty on which share transactions can be ignored for the purpose of applying the tracing concessions, then a wider test of director knowledge would be unnecessary.

If you wish to discuss this submission further please contact the Taxation Committee Convener, Mr Casey Plunket, via the committee secretary, Julie Smith, phone (04) 463 2967 or email julie.smith@lawsociety.org.nz.

Yours sincerely

A handwritten signature in cursive script that reads "Mary Jeffcoat".

Mary Jeffcoat
Vice President