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# “The Troubled Teen Years”: Is the Repeal of New Zealand’s LAQC Regime Required?

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*The possible repeal of the Loss Attributing Qualifying Company (LAQC) regime in New Zealand has been raised again. This most recent announcement was canvassed in the discussion document concerning the introduction of a new limited partnership with tax transparency to facilitate venture capital investment. While the repeal of the LAQC regime has not eventuated, this article will argue that the rules for LAQC members utilising allocated losses are inadequate. This means that the LAQCs could compromise the integrity of the New Zealand tax base. Indeed, it will be argued that the loss restriction rules for the new limited partnerships are also inadequate. For both types of tax transparent companies, this article argues for the introduction of a broad loss restriction rule limiting the utilisation of allocated losses to a member’s financial exposure amount. Also, important differences in the governance regimes between the two transparent companies are identified to support the continued availability of LAQCs.*

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## 1.0 INTRODUCTION

The possible repeal of the Loss Attributing Qualifying Companies (LAQC) regime was announced in the discussion document on proposed reforms to facilitate venture capital investment (the Discussion Document).<sup>2</sup> This announcement was framed on the proposition that the LAQC regime may be superfluous with the introduction of a new limited partnership with transparent tax treatment.<sup>3</sup> However, given past statements by the New Zealand Government and New Zealand Inland Revenue (Inland Revenue) about the leakage of tax revenue due to the LAQC regime, the real reason may relate to improving the integrity of the tax system. Indeed, the LAQC regime, now in its fifteenth year of operation, may be perceived as a ‘troubled teen’ that should be ‘shown the door’. However, with a

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<sup>2</sup> Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), p 7.

<sup>3</sup> See n 2, p 7. The draft legislation introducing the new limited partnership regime was originally released on 7 August 2007: Limited Partnerships Bill 2007 (referred to as ‘Limited Partnership Bill 2007 (August)’ or ‘August Bill’ in this article). Since then, submissions have been received resulting in the release in November 2007 of: (a) Inland Revenue, *Officials’ Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, (Wellington, November 2007); and (b) Commerce Committee (House of Representatives), *Limited Partnerships Bill: Government Bill*, (Wellington, December 2007) with attached recommended amendments to Limited Partnerships Bill 2007 (referred to as ‘Limited Partnership Bill 2007 (November)’ or ‘November Bill’ in this article).

'little bit of discipline' could this 'troubled teen' be put 'back on track' and continue to be a popular business form in New Zealand?

This article will initially outline, in section 2 the LAQC regime and the extent to which it has been utilised as a business form. The article will then explore concerns expressed about the LAQC regime in section 3 and how its tax transparency could compromise New Zealand's tax system. The article will argue, in section 4, that the primary source of these concerns arise from inadequate loss restriction rules applying to losses allocated to LAQC members. To determine what could be the appropriate restrictions, section 5 of this article will consider the loss restriction rules applying to tax transparent companies in the United States of America (the 'United States'). The "at risk rules", "passive rules" and "streaming rules" in the United States will be compared (in sections 6, 7 and 8, respectively) to the rules applying to LAQCs and as well as those proposed for the new limited partnership regime.

The United States has been chosen due to its extensive history with tax transparent companies and venture capital investment.<sup>4</sup> Through this analysis, it will be argued that there are deficiencies in the loss restriction rules applying to LAQCs, as well as those proposed for the new limited partnership regime.

This article will argue in section 9 that the retention of the LAQC regime is possible provided adequate loss restriction rules are introduced, with similar rules applying to all New Zealand taxpayers regardless of the business form adopted. Final conclusions are set out in section 10.

## 2.0 THE LAQC REGIME AND UTILISATION

The LAQC is an example of a growing trend referred to as 'tax transparent companies'.<sup>5</sup> Tax transparent companies can be seen as providing the hybridity of business forms, being the corporation and the general partnership, where attributes of both are combined. The combined attributes are a corporation's separate legal entity status and limited liability, with a general partnerships' flow-through taxation.<sup>6</sup> For consistency, the term 'member' is used in this article to describe an equity investor in a tax transparent company even though they might be known as shareholder or partner or otherwise. Examples of tax transparent companies around the world include the United States' S Corporations, Limited Liability Companies (LLC), the United Kingdom's Limited Liability Partnership (LLP) and Australia's Incorporated Limited Partnership (ILP).<sup>7</sup> Important terms associated with tax transparency are 'allocations' and 'distributions'. 'Allocations' refers to the allocating of income or losses for tax purposes directly to members, even though legally the income and/or loss may have been earned or incurred by the business form. 'Distributions' refers to the payment or transfer of assets (including money) to members of the transparent company.

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<sup>4</sup> Also, the New Zealand Government referred to the United States (as well as to Australia) as a jurisdiction in formulating the proposed loss restriction rules to apply to new limited partnerships; see Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), p 34.

<sup>5</sup> B Freudenberg, "Are Transparent Companies the Way of the Future for Australia?", (2006) Vol 35:3 *Australian Tax Review* 200.

<sup>6</sup> The term 'company' is adopted to indicate the characteristics of separate legal entity status and limited liability, even though some jurisdictions have used the term 'partnership' in describing their transparent company.

<sup>7</sup> It should be noted that Australia's ILP is not available for general business use and is only available to facilitate venture capital investment. See s 53D(3) Partnership Act 1892 (NSW); s 87(2) Partnership Act 1958 (Vic); s 75 Partnership Act 1891 (Qld); s 57(2) Partnership Act 1963 (ACT); s 51D(3) Partnership Act 1891 (SA); and s 55(2) Partnership Act 1997 (NT). Every state, except for Queensland, provides for ILPs to be used for other purposes, as provided by regulation (of which there is none at the moment).

New Zealand legislated for the LAQC regime in 1992, which arose from a review of New Zealand's tax system by the Valabh Committee.<sup>8</sup> The LAQC regime was proposed for closely-held corporations to improve tax neutrality with respect to the treatment of general partnerships. Whether the introduction of the LAQC has totally achieved tax neutrality is debatable since there are still a number of inconsistencies between LAQCs and general partnerships. These inconsistencies include the treatment of part-year losses, foreign income and non-resident members.<sup>9</sup>

The LAQC has been described as a 'special tax rule company',<sup>10</sup> as it is a New Zealand corporation that meets certain eligibility requirements and elects for the application of special tax rules to provide for tax transparency rather than the corporate imputation system.<sup>11</sup> However, the LAQC is not a fully transparent company, but instead is a 'partial loss transparent company', allowing the direct allocation of losses to members, with income being initially assessed at the entity level.<sup>12</sup>

A difference between LAQCs and other New Zealand corporations is the treatment of unimputed dividends paid to LAQC members. Essentially, unimputed dividends represent profits that have not been subject to corporate tax. For a normal corporation, a member receiving an unimputed dividend would be assessed on the dividend without being able to decrease their tax liability with an imputation credit. In contrast, an LAQC member receiving an unimputed dividend is regarded as receiving exempt income and is therefore not assessable on it.<sup>13</sup> This treatment allows tax preferences to flow through to

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<sup>8</sup> Consultative Committee on the Taxation of Income from Capital, *Taxation of Distributions from Companies – Final Report*, (Auckland, July 1991), pp 7-22. The Consultative Committee is more commonly known as the Valabh Committee. The Valabh Committee observed that there were inconsistencies in how a closely-held firm was taxed if it was conducted through a corporation rather than through a general partnership or sole proprietor.

<sup>9</sup> B Freudenberg, "Is the New Zealand Qualifying Company Regime Achieving its Original Objectives?", (2005) Vol 11:2 *New Zealand Journal of Taxation Law and Policy* 185, pp 205-208.

<sup>10</sup> B Freudenberg, "Are Transparent Companies the Way of the Future for Australia?", (2006) Vol 35:3 *Australian Tax Review* 200, pp 201-202.

<sup>11</sup> New Zealand's regime actually created two types of entities, with LAQCs being a subset of Qualifying Companies (QC). QCs have their own eligibility requirements, with LAQCs having four requirements additional to these. The focus of this article will be primarily on LAQCs. Sections HA 1 to HA 9 Income Tax Act 2007 (ITA 2007) essentially prescribes ten eligibility requirements which need to be satisfied at all times of the year for a corporation to be treated as a QC. These requirements relate to: residency, the number of members, members' election, members' liability, directors' election, corporate members' status, trustee members' status, not being a unit trust, not losing LAQC status, and not earning excessive foreign income. In addition to the ten eligibility requirements for a QC, for a corporation to become an LAQC, there must be only one class of share, a further member and director election, no avoidance arrangement, and at all times the corporation must be a QC: ss HA 5 and HA 10 ITA 2007.

<sup>12</sup> An imputation system applies to the LAQC and other New Zealand corporations. This means that the payment of corporate tax is recorded in the LAQC's imputation credit account: s OB 4 ITA 2007. The imputation credits are then attached to the dividends paid out: s OB 30 ITA 2007. An LAQC member is only assessable on an LAQC's taxable income after an actual payment of a dividend. The LAQC must impute any dividend payment to the fullest extent possible, known as an imputed dividend: s HA 15 ITA 2007. A member receiving an imputed dividend from an LAQC will include the dividend in their assessable income. The imputation credit is also included in their assessable income. The member can then offset their tax liability on the receipt of this dividend with the imputation credit: ss HA 14 and HA 15 ITA 2007. The top individual marginal tax rate is currently 39 percent, so for an individual on the top marginal rate an effective additional six percent tax rate would apply to the receipt of a fully imputed dividend. From 1 April 2008, this differential will be nine percent when the corporate tax rate drops to 30 percent.

<sup>13</sup> Sections HA 16 and CW 15 ITA 2007.

LAQC members.<sup>14</sup> One major tax preference in New Zealand is the absence of a comprehensive capital gains tax (CGT), which could essentially flow through to LAQC members untaxed.<sup>15</sup>

Another advantage of LAQCs over other corporations is that losses are directly allocated to members, whereas, with corporations, they are trapped at the entity level to be carried forward to offset against future income earned by the corporation.<sup>16</sup> LAQC losses are allocated to members in the ratio of the number of shares held by all members during an income year on a per share, per day basis, known as their 'effective interest'.<sup>17</sup>

The New Zealand Government's view towards tax transparent companies has not always been consistent. This can be illustrated by the Government's effective elimination of a transparent company, the special partnership, from 1986 through to 2004.<sup>18</sup> This elimination was achieved by prohibiting the pass-through of losses to members, and instead requiring losses to be carried forward in the special partnership for offset against its future assessable income (known as the 'loss limitation rule').<sup>19</sup> These amendments were thought necessary to counter tax shelter arrangements.<sup>20</sup> The loss limitation rule has now been repealed, with the new deferred deduction rules<sup>21</sup> stated as providing sufficient protection against abusive tax schemes.<sup>22</sup>

Since being introduced in 1992, the LAQC has become a popular business form in New Zealand with LAQCs accounting for approximately one-quarter of corporation tax return lodgements, with 91,450 lodgements in 2005. This compares to 301,560 other corporations, 208,670 trusts,<sup>23</sup> 144,990 general partnerships, and 170 special partnerships. Sole proprietors accounted for the largest number of tax

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<sup>14</sup> It should be noted that any dividends received from a subsidiary corporation by an LAQC are assessable to the LAQC, as there is no exemption in relation to wholly-owned subsidiaries.

<sup>15</sup> If a New Zealand corporation holds an appreciating asset, the sale of this asset will not result in assessable income for the corporation. However, if this untaxed profit were distributed via a dividend, it would be treated as an unimputed dividend and fully assessable to corporate members. Such an amount would be assessed at their appropriate income tax rate without any imputation credit to offset the resulting tax liability. It should be noted that New Zealand does have s DB 26 ITA 2007, which assesses amounts from profit-making undertakings.

<sup>16</sup> The availability of these losses to members allows them to offset other assessable income, thereby reducing members' overall tax burden. The value of losses deteriorates with time when the time value of money is taken into account, so earlier utilisation of losses is beneficial.

<sup>17</sup> There is no option in relation to the treatment of an LAQC's losses, as any losses incurred while a corporation is an LAQC must be directly allocated to its members: s HA 20 ITA 2007. Once allocated, the losses are no longer available to the corporation (s HA 21 ITA 2007), nor can the LACQ offset the losses to other group corporations prior to attributing them to its members (s HA 22 ITA 2007).

<sup>18</sup> Previously, s HD 1 Income Tax Act 1994 (ITA 1994); s 42 Taxation Administration Act 1994.

<sup>19</sup> Previously, s HC 1 ITA 1994.

<sup>20</sup> M Stewart, "Venture Capital Tax Reform in Australia and New Zealand", (2005) Vol 11:2 *New Zealand Journal of Taxation Law and Policy* 216, pp 235-239. Prior to these amendments, special partnerships offered both limited liability and the ability to pass through losses to members, and were a popular structure for investors in films and livestock. Committee of Experts on Tax Compliance. *Tax Compliance: Report to the Treasurer and Minister of Revenue*, (Wellington, December 1998), Ch 6: Tax Mitigation, Avoidance and Evasion, p 144.

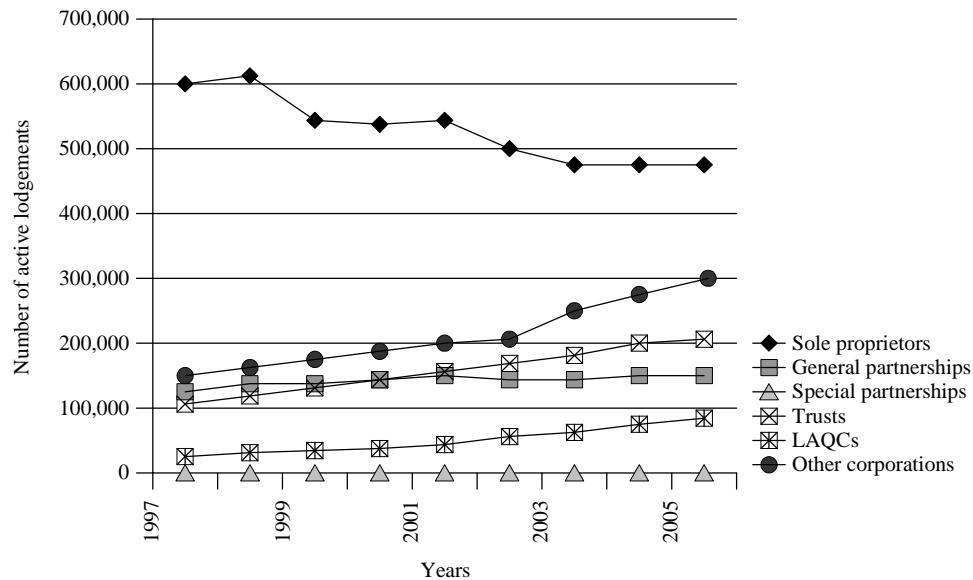
<sup>21</sup> Sections GB 45 to GB 49 ITA 2007.

<sup>22</sup> Inland Revenue, *General and Limited Partnerships – Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006).

<sup>23</sup> Of course, not all trusts would be used for conducting business operations. Unfortunately, the data did not disclose the trusts' activities.

return lodgements with 472,800 in 2005. Figure 1 below demonstrates an increasing trend in the number of business forms lodging tax returns between 1997 and 2005 for all business forms except for sole proprietors.

**Figure 1: New Zealand Tax Lodgements<sup>24</sup>**



With the extent of LAQC lodgements, the New Zealand Government has expressed concern about the potential exposure LAQCs present to tax revenue. For example, the Committee of Experts on Tax Compliance recommended that the Government examine LAQCs to determine whether their use as tax avoidance vehicles was a threat to the tax base.<sup>25</sup> The Committee of Experts went so far as to state that the LAQC provisions should be repealed if they could not be adequately amended, in order to prevent LAQCs being used as vehicles for tax shelters.<sup>26</sup> This concern has meant that New Zealand tax officials have ruled strictly on the LAQC regime since it appears too 'pro-taxpayer'.<sup>27</sup> Also, in 2003 the then New Zealand Revenue Minister, Dr Michael Cullen, noted the use of LAQCs for mass market tax driven schemes.<sup>28</sup> Mechanisms used included loans provided on explicit limited or non-recourse terms, or being made to an arrangement-specific corporation, often an LAQC, and only secured over its assets or perhaps, the shares of the corporation.<sup>29</sup> In 2004, Inland Revenue noted a potential tax avoidance

<sup>24</sup> The data detailing the number of active entities filing tax returns were provided to the author by Inland Revenue in an email dated 22 March 2007.

<sup>25</sup> Committee of Experts on Tax Compliance. *Tax Compliance*, (Wellington, December 1998), Report to the Treasurer and the Minister of Revenue, Ch 6: Tax Mitigation, Avoidance and Evasion, para 6.18.

<sup>26</sup> See n 25, p 145. It was noted that LAQCs enable middle-income taxpayers to pool funds to invest in forestry, and to take advantage of tax preferences provided to this industry.

<sup>27</sup> B Gilchrist, "IRD Lacks Flexibility on QCs", (1998) Vol 77:11 *Chartered Accountants Journal* 61.

<sup>28</sup> M Cullen, "Revenue Minister Speaks on Tax Matters", (Address to the Hawke's Bay Financial Planners and Insurance Advisors Association, 4 July 2003).

<sup>29</sup> Inland Revenue, "Deferred Deduction Rule", (2004) Vol 16:1 *Tax Information Bulletin* 58, p 59.

scheme involving taxpayers selling their private homes to LAQCs, and then renting the property back from the LAQC and claiming a tax loss.<sup>30</sup>

Given these statements, it should come as no surprise that the possible repeal of the LAQC regime has been again raised. The Ministers of Revenue and Finance announced that the LAQC regime might be repealed with the introduction of the new limited partnership regime. The new limited partnership regime will replace New Zealand's 'special partnership',<sup>31</sup> and is in response to lobbying for a new business form with transparent tax treatment to facilitate venture capital investment.<sup>32</sup>

The proposed legislation introducing the new limited partnership regime with tax transparency was initially released in August 2007 with its own loss restriction rules (the August Bill).<sup>33</sup> Since then submissions have been received resulting in the release in November 2007 of an Officials' Report by Inland Revenue,<sup>34</sup> and the Commerce Committee's Report with attached revised proposed Bill (the November Bill).<sup>35</sup>

Unlike the LAQC, the proposed transparency applying to the new limited partnership regime would apply to both income and losses, and will not have the LAQC's strict eligibility requirements.<sup>36</sup>

The possible repeal was canvassed in the following statement in the Discussion Document:<sup>37</sup>

"The introduction of new partnership flow-through rules does raise the question of whether it is necessary to retain similar tax treatments offered by the qualifying company (QC) and loss attributing qualifying company (LAQC) rules. It is inconsistent with the Tax Review's principles to proliferate our laws with a variety of flow-through treatments."

However, this article argues that the substantive reason is not the 'proliferation' of laws, but inadequate restrictions for allocated losses to LAQC members. Currently, there are only minimal restrictions applying to such allocated losses. In comparison, allocated losses for the new limited partnerships are to be subject to a 'partner's basis', which is similar to the 'membership cost basis' rule discussed in section 5 of this article.<sup>38</sup>

The ability of LAQC members to have largely unfettered use of allocated losses is inconsistent with overseas practices, as well as those proposed for the new limited partnerships. In the United States, the

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<sup>30</sup> Inland Revenue, "Tax Avoidance Involving LAQCs and the Family Home", *Media Release* (19 July 2004), and Inland Revenue, *Revenue Alert RA 07/01*, (Wellington, December 2007). Inland Revenue has stated that it considers that such arrangements are often undertaken for tax avoidance purposes.

<sup>31</sup> This is similar to limited partnerships established in other jurisdictions, requiring re-registration every seven years.

<sup>32</sup> Inland Revenue, *Limited Partnerships Bill: Commentary on Parts 5 and 6 of the Bill – Associated Tax Changes*, (Wellington, August 2007), p 1.

<sup>33</sup> Limited Partnerships Bill 2007 (August).

<sup>34</sup> Inland Revenue, *Officials' Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, (Wellington, November 2007).

<sup>35</sup> Commerce Committee (House of Representatives), *Limited Partnerships Bill: Government Bill*, (Wellington, December 2007) with attached amendments to the Limited Partnerships Bill 2007. This regime will commence on 1 April 2008.

<sup>36</sup> The new s HG 2 ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 2 in the August Bill).

<sup>37</sup> Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), p 7.

<sup>38</sup> The new s HG 11 ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 11 in the August Bill).

loss restriction rules include restricting usage to the amount that the member has invested in the transparent company ('membership cost basis'), to determining the 'economic' amount that the member has at risk (the 'risk rules'). There are also rules that quarantine losses dependant on the member's involvement in the business activity ('passivity rules') and rules addressing the preferential direction of losses to some members over others ('streaming rules').<sup>39</sup> In comparison, allocated LAQC losses are subject to the one class of membership interest rule and an at risk rule that looks at whether the value of the membership interest is vulnerable to change due to losses generated by the LAQC.<sup>40</sup>

Before analysing the loss restriction rules in more detail, the potential for tax transparency to jeopardise tax revenue and the integrity of the tax system are discussed next.

### 3.0 INTEGRITY OF TAX SYSTEM

It is clear, in the author's view, that tax transparency can cause potential tax revenue leakage if members are able to deduct losses (including tax preferences) in excess of their financial exposure. Example 1 below provides a simple scenario to demonstrate how unfettered access to losses could result in the tax system funding an investment and thus cause revenue leakage.

#### Example 1: Funding Investment

Assume that a member (Cooper) on the highest marginal tax rate (39 percent) invests \$10,000 into a tax transparent company. The \$10,000 represents the extent of Cooper's financial exposure to the business operations. The transparent company borrows another \$40,000 from a third party. The business invests the money, and generates tax losses of \$50,000 for the first three years. After three years, it is projected the business may generate income.

If Cooper were able to utilise these tax losses to offset against other assessable income, Cooper would not pay tax on \$50,000 of income, because the \$50,000 worth of tax losses could be offset against assessable income of \$50,000. Over the three years, this would amount to a tax saving of \$19,500 (being \$50,000 x 39 percent).

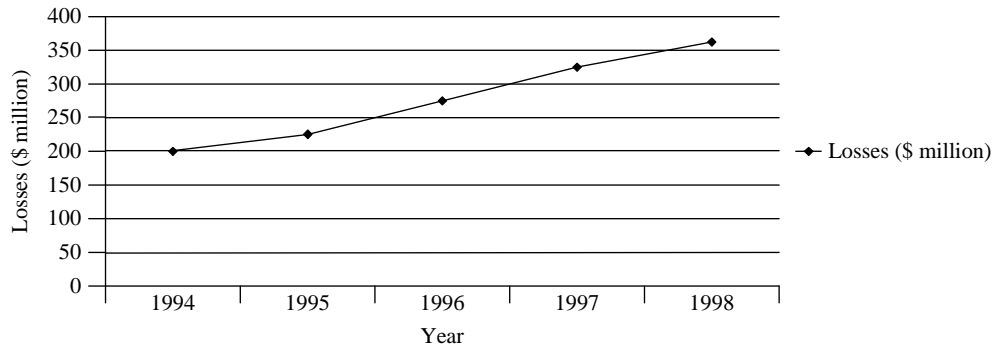
The scenario in Example 1 means that regardless of whether the investment ever delivers positive returns to Cooper, Cooper has an effective return of \$19,500 over the first three years. This means that Cooper recovers the initial \$10,000 investment plus an additional \$9,500. This represents a return to Cooper of 95 percent over the first three years. This return is facilitated by the tax system funding the investment by lowering Cooper's overall tax burden. If not for the tax savings, Cooper may not have made the investment at all. This scenario demonstrates how a country's tax system can fund or decrease the effective cost of capital for an investor and distort investment decisions. While it is not possible to provide accurate figures of the amount of New Zealand revenue at risk, from the available data there was \$360 million worth of losses following through LAQCs in 1998. This represented an average annual increase of 16 percent from 1994 in the amount of losses flowing through LAQCs. Figure 2 below illustrates the increase in losses allocated through LAQCs from 1994 to 1998.

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<sup>39</sup> In addition to the restrictions to be canvassed in this article, there are further restrictions on losses not discussed. For example, the United States also has hobby loss rules: s 183 Internal Revenue Code 1986 (US) (IRC 1986 (US)). The hobby loss rules are not relevant to this article as it is envisaged that the transparent company is conducting a business with a profit motive.

<sup>40</sup> Additionally, there are broader rules that apply to all taxpayers, such as the deferred deduction rule.



**Figure 2: New Zealand: LAQC Losses<sup>41</sup>**

#### 4.0 INTEGRITY MEASURES REQUIRED

The United States has had an extensive history of providing tax transparency to business forms that provide members with limited liability and a separate legal entity status. This originated in 1958 when the S Corporation regime was introduced, and more recently with the confirmation that a new business form, the LLC, was eligible for tax transparency.<sup>42</sup> Indeed, from 1997 many entities, excluding United States corporations, can simply Check(tick)-the-Box to determine their tax treatment as a general partnership or as a corporation.<sup>43</sup> In 2003, there were 3,341,606 S Corporations lodging tax information returns, and 1,091,502 for LLCs.<sup>44</sup> This compares to 2,047,475 C Corporations, 757,194 general partnerships, 378,921 limited partnerships and 19,710,079 sole proprietors. These numbers demonstrate that the utilisation of transparent companies in the United States is popular. This may not be a surprise given the classical tax system applying to C Corporations in the United States.<sup>45</sup> In the author's view, the United States Government must have some confidence that adequate measures are in place to protect tax revenue from this 'tax transparency'.

It is important to appreciate that tax transparency is granted to S Corporations and LLCs pursuant to different provisions of the Internal Revenue Code 1986 (US) (IRC 1986 (US)). S Corporations are normally corporations<sup>46</sup> incorporated under state law that qualify and elect for transparent treatment

<sup>41</sup> Inland Revenue, *Supplementary Briefing Papers: Vol 1 – Tax Policy*, (Wellington, November 1999), p 42.

<sup>42</sup> In 1988, the Internal Revenue Service (US) ruled that the Wyoming LLC would be classified as a general partnership for tax purposes; see Internal Revenue Service (US), Revenue Ruling 88-76, 1988-2 C.B. 361.

<sup>43</sup> It should be noted that certain business forms, such as entities actually incorporated under state law and publicly traded entities, do not qualify for this election, and are still classified as a corporation for United States tax purposes.

<sup>44</sup> Indeed the correct figure of LLCs could be much larger, around 3 million. This is due to single member LLCs being recorded by reference to the status of their members rather than as an LLC. For example, a single member LLC would be recorded as a sole proprietor rather than as an LLC.

<sup>45</sup> 'Tax transparency' in the United States means business income is subject to tax at only one level, being the member level, rather than at two levels, being the corporation and its members.

<sup>46</sup> It is possible for an LLC to elect for C Corporation tax treatment and then do a subsequent S Corporation election if the eligibility requirements are satisfied.

pursuant to Sub-Chapter S of the IRC 1986 (US).<sup>47</sup> Whereas LLCs are new business forms different from 'corporations', which can elect for transparent treatment pursuant to the general partnership tax provisions of Sub-Chapter K of the IRC 1986 (US).<sup>48</sup> Even though both Sub-Chapters S and K provide tax transparency, there are subtle differences between them. Some of the differences are highlighted in the analysis that follows.

The loss restriction rules operating in the United States will now be analysed, as well those for LAQCs and new limited partnerships. This analysis will consider the following categories of restrictions: the membership cost basis (section 5), at risk rules (section 6), passivity rules (section 7) and streaming rules (section 8).

## 5.0 MEMBERSHIP COST BASIS

In the United States, an initial restriction on members utilising allocated losses is the measurement of the member's equity investment in the transparent company ('membership cost basis').<sup>49</sup> This restriction allows members to utilise allocated losses only to the extent of their membership cost basis. If allocated losses exceed this amount, then excess losses may be carried forward by the member until the membership cost basis increases or the transparent company allocates profits.<sup>50</sup>

New Zealand LAQCs do not have a membership cost basis restriction on allocated losses to members. This may be attributed to the absence of a comprehensive CGT in New Zealand and the desire to ensure tax neutrality with disposals of capital assets by general partnerships.<sup>51</sup> The application of a membership cost basis rule to LAQC members may have meant that profits arising from the sale of capital assets could be assessable to the LAQC members on distribution. This situation arises following the United States' approach to the extent that there is membership cost basis, actual distributions are tax free; however, once the membership cost basis is exhausted then distributions are assessable.<sup>52</sup> Nevertheless, this situation could be dealt with by exempting unimputed dividends.

Another reason for the absence of a membership cost basis rule could be due to the LAQC being a partial loss transparent company without income being automatically allocated members. The application of a membership cost basis rule would require some mechanism for LAQC members to

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<sup>47</sup> Section 1361 IRC 1986 (US). Broadly, for S Corporation status to be obtained the corporation itself and its members must be United States residents with only one class of membership interest, a membership not exceeding 100, and a valid election for S Corporation status. Additionally, certain trading activities and asset holdings are prohibited.

<sup>48</sup> For a discussion about how LLCs were introduced in the United States, see B Freudenberg, "Are Transparent Companies the Way of the Future for Australia?", (2006) Vol 35:3 *Australian Tax Review* 200. The four main types of entities that may be taxed pursuant to Subchapter K are general partnerships, limited liability partnerships, limited partnerships, and LLCs.

<sup>49</sup> In the United States, this is known as the 'outside cost basis'.

<sup>50</sup> In the United States, the allocation of losses decreases the member's outside cost basis of their membership interest, but not below zero, as well as the outside cost basis of the member-to-transparent company loans: s 705(a)(2)(A) IRC 1986 (US). If the outside cost basis amount at the end of the year is exceeded by the losses, the member may carry the excess losses forward: ss 1366(d) and 704(d) IRC 1986 (US).

<sup>51</sup> B Freudenberg, "Is the New Zealand Qualifying Company Regime Achieving its Original Objectives?", (2005) Vol 11:2 *New Zealand Journal of Taxation Law and Policy* 185, p 190. However, s DB 26 ITA 2007 assesses amounts from profit-making undertakings.

<sup>52</sup> The respective cost basis of a membership interest in an S Corporation must be reduced by the amount of actual distributions: ss 1368(b)(1) and 1367(a)(2)(A) IRC 1986 (US). The adjustments to the cost basis of a membership interest because of allocations of current year S Corporation income or losses must occur prior to determining the tax treatment of actual distributions to members.

track their membership cost basis even though profits are not taxed annually to them.<sup>53</sup> Furthermore, the Government may have considered that the eligibility requirement of one class of membership interest would reduce the potential for the manipulation of loss allocation through LAQCs.<sup>54</sup>

Whatever the reason, by not introducing a membership cost basis rule for LAQC members New Zealand may have compromised the integrity of its tax system. For example, the goal of tax neutrality between LAQCs and general partnerships does not appear to take into account the fundamental legal differences between these two forms and the effect this has on members' liability exposure. This deficiency is now acknowledged; as allocated losses for New Zealand's new limited partnership regime are to be subject to a membership cost basis restriction.<sup>55</sup> While there were a number of submissions objecting to such a rule, it has been retained, with modifications, in the November Bill.<sup>56</sup> The aim of this restriction is to ensure that the net loss claimed by a limited member reflects its actual level of 'economic loss'.<sup>57</sup> However, the November Bill does extend the rule in part to 'general' members as well as to 'limited' members of the new limited partnership.<sup>58</sup>

To illustrate the application of a membership cost basis rule with the facts presented by Example 1, Cooper would only be entitled to claim \$10,000 in losses and thus save tax of \$3,900. Cooper would carry forward the remaining \$40,000 of allocated losses until an increase in membership cost basis or the transparent company allocating income. As a result of this restriction, Cooper to-date has only received \$3,900 of the initial \$10,000 investment with no guarantee that any more returns will be forthcoming.

While the principle of membership cost basis appears simple, how the members' 'equity' contribution is measured can be contentious. For both S Corporations and LLCs, membership cost basis will equal the initial contribution for membership interest,<sup>59</sup> additional capital contributions,<sup>60</sup> and allocated income,<sup>61</sup> less both allocated deductions and actual distributions.<sup>62</sup> This means that the allocation of income or losses immediately adjusts the membership cost basis. The increasing adjustment for allocated income recognises the potential tax assessment for an S Corporation or LLC

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<sup>53</sup> To facilitate a cost basis rule, it may be necessary to make a notional allocation of profits to members to increase their cost basis.

<sup>54</sup> Section HA 10 ITA 2007.

<sup>55</sup> The new s HG 11 ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 11 in the August Bill). This was referred to as a 'partner's basis' in the legislation. Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), p 2.

<sup>56</sup> Objectors to the membership cost basis rule included Deloittes, Corporate Tax Group, KPMG, Kensington Swan and the New Zealand Institute of Chartered Accountants (NZICA): Inland Revenue, *Officials' Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, (Wellington, November 2007), p 20.

<sup>57</sup> See n 55, p 34.

<sup>58</sup> The new s HG 11(1)(b) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November). A general member is subject to the loss restriction rule when they have been a limited member within the last 60 days of the income year and continue to be so 60 days after the year end.

<sup>59</sup> Section 351 IRC 1986 (US) for S Corporations and s 722 IRC 1986 (US) for LLCs. Such contributions could be made by cash, property and/or future services.

<sup>60</sup> Regulation 1.446-1(a)(4) Treasury Regulations (US).

<sup>61</sup> Sections 1366, 1367 and 702 IRC 1986 (US).

<sup>62</sup> Sections 1367(a)(1), 705 and 752 IRC 1986 (US).

member.<sup>63</sup> Recognising the potential tax deductibility to a member allocated expenses (whether deductible or not) will decrease the membership cost basis.<sup>64</sup> An actual distribution (whether cash or property) to a member made by an S Corporation or an LLC will normally decrease the membership cost basis. However, an important difference between the two United States transparent companies is that LLC members are able to increase their membership cost basis by loans to the transparent company by third parties ('outside loan'), whereas S Corporations members may not. This exclusion for S Corporation members is not altered even if they guarantee the outside loan.

The rules for New Zealand's limited partnerships have some similarities with the United States approach. The Limited Partnerships Bill 2007 appears to adopt the second membership cost basis measure outlined in the Discussion Document.<sup>65</sup> The August Bill provided that the membership cost basis would be the addition of 'investments' and 'income' less 'distributions', 'deductions' and 'disallowed amounts'.<sup>66</sup> Each of these terms had its own defined meaning. The November Bill largely replicates this, although with some subtle differences.<sup>67</sup>

In the August Bill, 'investments' was defined to be the sum of: (a) the market value of contributions; (b) the amounts paid for assignments of capital contribution; (c) the consideration paid by the member under financial arrangements; and (d) the guaranteed amounts.<sup>68</sup> In the November Bill, 'capital contribution' has been altered so it refers back to the Limited Partnership Act meaning.<sup>69</sup> Furthermore, the inclusion of 'financial arrangements' has been excluded, as this is taxed pursuant to other provisions.<sup>70</sup> The term 'guaranteed amounts' has been replaced by the term 'secured amount' with a broader definition.<sup>71</sup>

In the August Bill, the term 'income' was defined to include: (a) income previously allocated to the member; (b) capital gain amounts in the current or prior years if the member is treated as a corporation;<sup>72</sup> and (c) income allocated to the member due to contributions to the partnership.<sup>73</sup> The

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<sup>63</sup> Sections 1366 and 1367(a)(1) IRC 1986 (US). For LLCs, ss 702 and 705(a)(1) IRC 1986 (US).

<sup>64</sup> For S Corporations, s 1367(a)(1) IRC 1986 (US), and for LLCs, s 705 IRC 1986 (US). For example, a fine or penalty while non-deductible would decrease the outside cost basis: s 162(f) IRC 1986 (US).

<sup>65</sup> The first proposed measurement of membership cost basis was the sum of the following: original investment plus value of additional contractual guarantee plus indemnities provided plus share of net income and prior equity injection. The second measure added the share of 'realised' capital gains previously recognised, less the share of realised capital loss previously recognised.

<sup>66</sup> The new s HD 11(3) ITA 2004, inserted by the Limited Partnerships Bill 2007 (August).

<sup>67</sup> The new s HG 11(3) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November).

<sup>68</sup> The new s HD 11(4)(a) ITA 2004, inserted by the Limited Partnerships Bill 2007 (August).

<sup>69</sup> The new s HG 11(12) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November), referring to the meaning in cl 32(2) Limited Partnerships Bill 2007.

<sup>70</sup> The new s HG 8 ITA 2007, inserted by the Limited Partnerships Bill 2007 (November).

<sup>71</sup> The new s HG 11(12) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November).

<sup>72</sup> Referring to s CD 33(7)(a) ITA 2004.

<sup>73</sup> The new s HD 11(4)(c) ITA 2004, inserted by the Limited Partnerships Bill 2007 (August).

November Bill clarifies the meaning of 'income' specifying that it includes current year as well as prior year's income.<sup>74</sup>

The term 'distributions' was defined in the August Bill to include: (a) market value of withdrawals; (b) amounts paid because of assignment of capital contributions to others; and (c) amounts of consideration paid to the member under financial arrangements.<sup>75</sup> The November Bill excludes 'financial arrangements', acknowledging that they are addressed through other provisions, and the term 'withdrawals' has been replaced with the more consistent term 'distributions'.<sup>76</sup>

The August Bill defined 'deductions' as being: (a) deductions allowed in prior years (except those denied pursuant to the loss restriction rule); (b) capital losses in current and prior years if the member is treated as a corporation;<sup>77</sup> and (c) deductions allowed in prior years due to certain assessable income amounts.<sup>78</sup> Similar to the alteration to the meaning of 'income', this definition in the November Bill is extended to include current year deductions as well.<sup>79</sup>

'Disallowed amounts' is defined as an investment that is made by a member within 60 days of the last day of income year if the investment is distributed or reduced within 60 days after year end.<sup>80</sup> There have not been any substantial amendments in the November Bill to this.<sup>81</sup>

A distinction originally made by the August Bill, was that the rule only applied to limited members of the new limited partnership, and not to general members.<sup>82</sup> In comparison, the United States applies the membership cost basis rule to all members regardless of whether or not the business form provides them limited liability protection.

The New Zealand Discussion Document raised concerns about the non-application of a membership cost basis rule to general members. This was because an LAQC could be used as a general member<sup>83</sup> of the new limited partnership, thus circumventing the loss restriction rules and still providing liability protection.<sup>84</sup> In the August Bill, the application of the loss restriction rule to limited members only was not clear, as the relevant section referred to any 'partner' [member] being allocated losses.<sup>85</sup> However, the rule as then drafted could only have practical application to limited members due to the definition

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<sup>74</sup> Inland Revenue, *Officials' Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, (Wellington, November 2007), p 20, and the new s HG 11(7) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November).

<sup>75</sup> The new s HD 11(4)(b) ITA 2004, inserted by the Limited Partnerships Bill 2007 (August).

<sup>76</sup> The new s HG 11(6) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November).

<sup>77</sup> Referring to s CD 44(7)(a) ITA 2007.

<sup>78</sup> The new s HD 11(4)(d) ITA 2004, inserted by the Limited Partnerships Bill 2007 (August).

<sup>79</sup> The new s HG 11(8) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November).

<sup>80</sup> The new s HD 11(4)(e) ITA 2004, inserted by the Limited Partnerships Bill 2007 (August).

<sup>81</sup> The new s HG 11(9) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November).

<sup>82</sup> Inland Revenue, *Limited Partnerships Bill: Commentary on Parts 5 and 6 of the Bill – Associated Tax Changes*, (Wellington, August 2007), p 17.

<sup>83</sup> Similar to other limited partnerships, there will be two categories of members, limited and general members: cl 8 Limited Partnerships Bill 2007. Only the limited members would be provided with liability protection, provided that they do not take part in management: cl 26 Limited Partnerships Bill 2007.

<sup>84</sup> See n 82, p 17.

<sup>85</sup> The new s HD 11 ITA 2004, inserted by the Limited Partnerships Bill 2007 (August).

of 'partner'<sup>86</sup> and that general members were excluded from making 'capital contributions' to the limited partnership.<sup>87</sup>

However, the November Bill now extends the loss restriction rule to general members, but only in the circumstance that the general member has switched status to a limited member within 60 days of the last day of the income year and remains so 60 days after the end of the income year.<sup>88</sup> This change, in part, appears to acknowledge that the membership cost basis rule for New Zealand's limited partnership does not only include capital contributions, but it includes other things such as guarantee amounts and allocated income.<sup>89</sup> Through the inclusion of these other amounts, a general member could have a membership cost basis in the limited partnership and therefore could utilise allocated losses.

In the author's view, the November Bill does not go far enough and the New Zealand loss restriction rule should apply to all members regardless of their liability status. This could have a number of positive outcomes. First, it is not apparent how meaningful the new switching rule is given that it only has a 120-day status,<sup>90</sup> and it may become necessary for future amendments if abuses become apparent.<sup>91</sup> Second, the alteration still does not prevent the use of a LAQC as a general member, thus allowing allocated losses to flow through the new limited partnership with minimal restriction.<sup>92</sup> Third, the application of the rule to all members acknowledges that the business form is not the only way for members to restrict their liability exposure, such as the use of non-recourse or limited recourse financing.

It should be noted that the membership cost basis for the new limited partnership does not include unrealised capital gains, even though it was mooted as deserving of inclusion in the Discussion Document. This was because unrealised capital gains represent capital at risk for the members, and their inclusion would decrease the tax disparity with members of a general partnership.<sup>93</sup> The New Zealand Institute of Chartered Accountants (NZICA) has continued to unsuccessfully argue for its inclusion.<sup>94</sup> The exclusion of unrealised gains may be due to the increase in complexity and compliance costs that its exclusion would have required, particularly the annual revaluations.<sup>95</sup>

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<sup>86</sup> In the Limited Partnerships Bill 2007 (August), s OB 1 ITA 2004 the definition of 'partner' only included limited members.

<sup>87</sup> Clause 17(2) Limited Partnerships Bill 2007.

<sup>88</sup> The new s HG 11(9) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November).

<sup>89</sup> The new s HD 11 ITA 2004, inserted by the Limited Partnerships Bill 2007 (August).

<sup>90</sup> One hundred and twenty (120) days, being 60 days before the end of the income year and 60 days afterwards. The need for a switching rule was originally raised in Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), p 41.

<sup>91</sup> Clause 21 Limited Partnerships Bill 2007 (August) provides that members may change their status from 'general' to 'limited' and vice versa.

<sup>92</sup> See n 90, p 42.

<sup>93</sup> See n 90, p 38.

<sup>94</sup> See n 74, p 22.

<sup>95</sup> New Zealand Institute of Chartered Accountants, *Limited Partnerships in New Zealand: A Proposal to Reform Special Partnerships, Part II Partnership Act 1908 - Submission to the Ministry of Economic Development*, (Wellington, February 2004), p 14, identifying that Inland Revenue and taxpayers could dispute valuations.

In both the United States and New Zealand, there are a number of contentious issues with measuring the membership cost basis. These include the treatment of: (a) member loans to the transparent company (including unpaid allocations) ('member loans'); (b) member guarantees of the transparent company's obligations; (c) loans to the transparent company from third parties ('outside loans'); and (d) the use of non-recourse or limited recourse financing by the member to fund their equity contribution. Each of these issues is analysed below with recommendations as to how they should affect the membership cost basis.

### 5.1 Member Loans to Transparent Company

In determining a member's equity investment, an issue arises as to whether member loans should be counted towards the membership cost basis. If a strict legal interpretation is taken, then a member's loan is clearly not equity, but is debt. However, whether a member's loan is indeed debt is not always clear because the terms of the loan may not be specified, and no interest may be payable with repayment at will. In these circumstances, even though a member's contribution is labelled a 'loan', it may be better categorised as equity. This is complicated by the recognition that member loans are an important source of financing for closely-held businesses, and unpaid allocation of profits could be labelled as a member loan to the transparent company.

While LAQCs do not have a membership cost basis limitation, the rule for the new limited partnership includes unpaid profit allocations but not members' loans.<sup>96</sup> A member's loan is not included because the term 'loan' is absent from the amounts specified as included in the membership cost basis.<sup>97</sup> This is re-enforced by the fact that a loan by a limited member to the limited partnership is specified as not being a 'capital contribution'.<sup>98</sup> For S Corporations and LLCs, unpaid profit allocations automatically increase a membership cost basis, as they increase the amount of retained profits in the business form. This occurs even though a member's unpaid allocation might technically rank equally with unsecured creditors upon winding up.<sup>99</sup>

For a member of an LLC, a member loan will automatically increase the membership costs basis.<sup>100</sup> This does not occur for an equivalent S Corporation member loan.<sup>101</sup> This inconsistency between the United States' transparent companies is because an LLC's transparent tax treatment is conferred by the application of the general partnership tax provisions in Sub-Chapter K IRC 1986 (US). For a member of a general partnership, a member loan is equivalent to an equity contribution, since it would be included in the member's assets exposed to joint and several liability. In comparison, S Corporations receive transparent treatment through the application of Sub-Chapter S, which has been drafted for a corporation entity providing limited liability protection to members and, thus, an unsecured member loan would rank equally with other unsecured creditors.

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<sup>96</sup> Unpaid allocations of profit is included through the new s HG 11 (7)(a) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 11(4)(c)(i) in the August Bill). Income that the partner has in previous income years been assessed under the new s HG 2 Limited Partnerships Bill 2007 (November) (s HD 2 in the August Bill).

<sup>97</sup> The new s HG 11 ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 11 in the August Bill).

<sup>98</sup> Clause 32(3) Limited Partnerships Bill 2007 (August).

<sup>99</sup> Section 6.40(f) Model Corporation Act (US) and s 405(d) Revised Uniform LLC Act (US).

<sup>100</sup> Section 752 IRC 1986 (US). Regulation 1.752-1(e) Treasury Regulations (US).

<sup>101</sup> MP Altieri and WJ Cenker, "Partnerships, LLCs, LLPs and S Corporations", (2002) Vol 72:10 *The CPA Journal* 40, p 45.

Nevertheless, this discrepancy between the United States transparent companies is largely mitigated as S Corporation members are able to use allocated losses to the extent of member loans in addition to their membership cost basis.<sup>102</sup> However, the potential for LLC members to have a larger membership cost basis means that actual distributions from the LLC are less likely to be assessable to them,<sup>103</sup> and subsequent transfers of membership interest will result in lower capital gains.<sup>104</sup>

In the author's view, if member loans (including unpaid allocations) are correctly being represented, in legal terms, as debts owing by the transparent company to the member that rank equally with unsecured creditors, then they should not be included in the membership cost basis. If, instead, a member loan ranks below unsecured creditors, then such a loan should increase the membership cost basis.

## 5.2 Member Guarantees

Another matter of contention is whether member guarantees of the transparent company's obligations should be included in the membership cost basis. This is an important consideration given that member guarantees can be a common occurrence for closely-held businesses, and cover such things as premises leases, equipment financing and overdraft facilities. In the author's opinion, the compelling consideration should be whether a member guarantee is regarded as a debt or equity contribution by the member. If it is regarded as debt, then consideration should be given to whether it ranks equally or below unsecured creditors on winding-up. If the ranking priority is lower than unsecured creditors, then the relevant obligation should increase membership cost basis. For debt ranking equal to or above secured creditors, then this debt should not increase membership cost basis.

This conclusion requires consideration of the legal nature of a guarantee. Indeed, a member's guarantee may be best regarded as neither equity nor debt, and instead is only a 'contingent' debt until called upon. If the guarantee is called upon and payment is made, then it is likely that the member would have a right of reimbursement from the transparent company through the rules of subrogation and contribution.<sup>105</sup> These rights as they relate to the transparent company could be treated at this later date as an equity contribution.<sup>106</sup>

New Zealand's limited partnership members' guarantees and indemnities can increase the membership cost basis.<sup>107</sup> However, the measurement of it has altered from the August Bill to the November Bill. In the August Bill, 'guarantee' amounts were defined as the lesser of: (a) member's partnership share of the limited partnership's debt to the extent of a given guarantee or indemnity; or

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<sup>102</sup> See n 101, p 45. Section 704(d) IRC 1986 (US). CCH, *US Master Tax Guide*, (New York, Commerce Clearing House Inc, 1987), p 116.

<sup>103</sup> To the extent that a member has sufficient membership cost basis, distributions are non-assessable. Once the membership cost basis is exhausted (reduced to nil), distributions in excess are likely to be assessable as a capital gain to the receiving member.

<sup>104</sup> The disposal of a membership interest will result in the member having a potential capital gain, the extent of which is determined by the membership cost basis.

<sup>105</sup> Now the reimbursement right is essentially a member loan.

<sup>106</sup> However, there could be problems with quantification because of the rules of contribution.

<sup>107</sup> The new s HD 11(4)(a)(iii) and (iv) ITA 2004, inserted by the Limited Partnerships Bill 2007 (August). Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, 2006), pp 35-36.



(b) the market value of property against which the guarantee may be enforced, treating the member's interest as having a market value of zero.<sup>108</sup>

Inland Revenue recommended that this measurement should be extended to include guarantees by persons 'associated with the [member] partner'.<sup>109</sup> This recommendation has been followed in the November Bill, with 'secured amounts' being defined as the lesser of:

- (a) The amount of limited partnership's debt secured by guarantee or indemnity of the member or associate of; or
- (b) The division of the amount of debt in (a) by number of members who are joint and severally liable for it; or
- (c) The market value of property against which the guarantee or indemnity can be enforced;<sup>110</sup> or
- (d) The division of the amount in (c) attributable to the member should the members be jointly and severally liable.<sup>111</sup>

The inclusion of guarantees in membership cost basis is maintained even though the Discussion Document identified that it would have its difficulties.<sup>112</sup> For example, a member could be assessed if there is a later reduction of the guarantee liability or quantum after a distribution by the limited partnership.<sup>113</sup> Another related problem identified is how to value guarantees and quantify potential liabilities.<sup>114</sup> In the November Bill, there does not seem to be any provision to reverse the allocation of losses utilised at a time of a member guarantee that subsequently decreases in worth.

For members of both S Corporations and LLCs, providing personal guarantees does not increase the membership cost basis.<sup>115</sup> It is not until the guarantee is called upon and paid that the membership cost basis is potentially adjusted.<sup>116</sup> However, it is understood that this exclusion can be circumvented through legal drafting of loan documentation to provide for a member loan. In this circumstance the member borrows from a third party and then on-lends it to the transparent company, thus creating a member loan. However, the documentation provides for the transparent company to repay the loan, with the creditor only having recourse against the member in the event of failure by the transparent company to fulfil these obligations. Through this mechanism, the relationship is similar to a member

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<sup>108</sup> The new s HD 11(7) ITA 2004, inserted by the Limited Partnerships Bill 2007 (August).

<sup>109</sup> Inland Revenue, *Officials' Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, (Wellington, November 2007), p 21.

<sup>110</sup> Treating the partner's interests as having a market value of zero.

<sup>111</sup> The new s HG 11(12) definition of 'secured amounts' ITA 2007, inserted by the Limited Partnerships Bill 2007 (November).

<sup>112</sup> Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), p 54.

<sup>113</sup> See n 112, p 54.

<sup>114</sup> New Zealand Institute of Chartered Accountants, *General and Limited Partnerships: Proposed Tax Changes - Submission on the Government Discussion Document*, (Wellington, 25 August 2006), p 14.

<sup>115</sup> Section 1368(b)(1) IRC 1986 (US). JK McNulty, *Federal Income Taxation of S Corporations*, (New York, The Foundation Press, 1992), p 101.

<sup>116</sup> Internal Revenue Service (US), Revenue Ruling 70-50, 1970-1 C.B. 178. At least if the member is subrogated to the creditor's claim against the S corporation: See n 112, p 101.

guarantee, but legally it is documented as a member loan. For both S Corporation and LLC members, member loans can increase the availability of allocated losses.<sup>117</sup>

Therefore, the author argues that, due to the difficulties identified above, New Zealand would be well advised not to include members' guarantees in determining membership cost basis. Also, the experience of the United States in circumventing the guarantee exclusion through member loans reinforces that member loans also should not allow for an increased access to losses when they rank equally or above unsecured creditors.

### 5.3 Outside Loans

Given the prior analysis, it may seem a foregone conclusion that outside loans<sup>118</sup> would not be included in the membership cost base. Indeed, an outside loan represents a debt contribution by an outside party rather than by a member, and therefore represents what the outside party has at risk.

In New Zealand, due to the absence of a membership cost basis rule for LAQCs, outside loans do not affect the utilisation of losses by LAQC members. Additionally, for the new limited partnership regime, outside loans are not included in the membership cost basis.<sup>119</sup> Similarly, an S Corporation's outside loan does not increase the membership cost basis.<sup>120</sup> However, curiously LLC members can increase their membership cost basis by outside loans.<sup>121</sup> This initial increase in cost basis is subsequently reversed when a LLC repays the outside loan, with each member treated as receiving a distribution of money equal to the member's share of the extinguished liability.<sup>122</sup>

Freidman correctly states that the treatment of LLC outside loans seems to lead to an 'odd result'.<sup>123</sup> This is because LLC members, like S Corporation members, are not personally liable for outside loans made to their transparent company due to their limited liability protection. This result appears to arise due to the application of the general partnership tax regime, Sub-Chapter K, to LLCs that caters for a general partnership where members have joint liability for outside loans. Sub-Chapter K does not appear to adequately deal with the broader range of business forms that can elect for tax treatment pursuant to it under Check-the-Box. Economically, such an outside loan for an LLC member could be considered equivalent to either a non-recourse or a limited recourse debt to the member. This is because a creditor only has recourse against the LLC for repayment of the outside loan, and the extent of the member's liability is restricted to their capital contribution.<sup>124</sup>

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<sup>117</sup> For an LLC, a member loan increases the membership cost basis. For an S Corporation, a member's ability to utilise losses is affected by their membership cost basis plus member loans.

<sup>118</sup> Outside loans are borrowings by the transparent company from third parties.

<sup>119</sup> The new s HG 11 ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 11 in the August Bill). See n 112.

<sup>120</sup> Sections 1361 and 1367 IRC 1986 (US).

<sup>121</sup> Outside loans are shared among members pursuant to their profit sharing ratios: reg 1.752-3(a)(3) Treasury Regulations (US).

<sup>122</sup> Section 752(b) IRC 1986 (US).

<sup>123</sup> HM Friedman, "The Silent LLC Revolution – The Social Cost of Academic Neglect", (2004) Vol 38:1 *Creighton Law Review* 24.

<sup>124</sup> Regulation 1.752-1(e) Treasury Regulations (US) and reg 1.752-01 Temporary Treasury Regulations (US).

Initially, for LLC members it would appear that the inclusion of outside loans in the membership cost basis gives greater potential to utilise allocated losses. However, the United States Treasury may not be concerned about potential revenue leakage since the increase in membership cost basis does not necessarily mean a corresponding increase in the ability for LLC members to utilise an LLC's losses. This is due to the application of other loss restriction rules that recognise the limited liability protection offered by the LLC form.<sup>125</sup> However, the advantage of a greater membership cost basis is that actual distributions to LLC members are less likely to be taxable in contrast to a comparable S Corporation.<sup>126</sup>

In the author's view, the treatment of outside loans for LLCs highlights the problem of applying general partnership tax provisions to transparent companies when fundamental legal differences have not been taken into account, particularly in relation to members' liability exposure. These legal differences affect what is an appropriate measurement of members' equity investment in an entity. The author would also argue that additional safeguards are required when transparent tax treatment is applied to transparent companies compared to general partnerships.

#### **5.4 Non-Recourse Financing**

Central to the idea of the membership cost basis restriction is that the greater the equity a member has invested in a transparent company, the greater their ability to utilise allocated losses. However, what should be the result if members increase their equity contribution without necessarily increasing the amount of their financial exposure? The ability to increase equity without a corresponding increase in financial exposure can be achieved by members borrowing on non-recourse or limited recourse terms,<sup>127</sup> and then using these borrowed funds to subscribe for membership interests in the transparent company. If the member does not meet their obligations to repay a limited recourse loan, then the creditor only has recourse against the secured asset and the member has no further personal liability. Through such mechanisms, the member's other assets are not at risk if default on the loan occurs. The asset used as security for the limited recourse loan may just be the subscribed membership interest itself. Through such borrowings, members can increase their equity contribution without actually increasing their overall economic financial exposure.

Limited recourse borrowings of this nature can achieve an economic financial exposure for the member similar to that where the transparent company had raised finance through an outside loan. This is because an outside loan to the transparent company is economically equivalent to a limited recourse loan to the member secured over the membership interest. This is because the member's financial exposure to the outside loan is only as great as their equity contribution.

Members' ability to increase their membership cost basis by such non-recourse or limited recourse borrowings, and thereby increase access to allocated losses, is inconsistent with the treatment of outside loans. Such a consequence results in a breach of tax neutrality.<sup>128</sup> If this analysis is correct, then the use of non-recourse or limited recourse borrowings by members could artificially inflate tax deductions (losses), and thereby lead to the tax system distorting investment decisions.

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<sup>125</sup> Particularly the 'at risk rule', which is discussed later in this article.

<sup>126</sup> Actual distributions will not be assessable to the extent that a member has a membership cost basis.

<sup>127</sup> If member borrowings are on a non-recourse basis, specific property has been pledged normally as sole security for the loan.

<sup>128</sup> This is not the situation for LLCs.

In 2004, New Zealand introduced the 'deferred deduction rules', which have broad application for the use of non-recourse borrowings.<sup>129</sup> These rules acknowledge that taxpayers, through the use of non-recourse or limited recourse borrowings, can limit their risk exposure contractually.<sup>130</sup> The deferred deduction rules require a taxpayer to defer deductions or losses arising from a transaction involving the acquisition of certain intangible property and software financed by a majority of limited recourse loans, when gross income from the arrangement is less than the total deductions or losses.<sup>131</sup> In such circumstances, losses are deferred until income arises from the arrangement, or if no income arises, the deferral will become permanent.<sup>132</sup>

While the deferred deduction rules apply to all New Zealand taxpayers, their application is restricted to schemes involving intangible property.<sup>133</sup> Curiously, the rules do not apply to arrangements involving the limited recourse financing of tangible property, such as the forestry schemes used in the *Accent Management* case.<sup>134</sup> It appears that limited recourse financing of tangible property was excluded because these schemes are widely established.<sup>135</sup> However, in the *Accent Management* case, the potential amount of revenue at risk was stated to be greater than \$3 billion over a 50-year timeframe.<sup>136</sup> In the author's opinion, excluding tangible property means that the integrity of New Zealand's tax system could be compromised and such 'grand fathering' of entrenched schemes is not desirable.

The restricted scope of New Zealand's deferred deductions rules in this way was acknowledged in the current debate about the new limited partnership regime. The deferred deduction rules were not considered sufficient to restrict the use of allocated losses to the amount of members' economic loss.<sup>137</sup> However, it does not appear that the Government has excluded non-recourse financing from increasing the membership cost basis for the new limited partnerships. This is because the definition of 'investments', in determining membership cost basis, refers to the market value of capital contributions

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<sup>129</sup> Sections GB 45 to GB 48 ITA 2007.

<sup>130</sup> Section GB 48(3) ITA 2007: A limited recourse loan is defined as a financial arrangement involving the provision of money and has an effect or economic effect of: (a) relieving the borrower from obligation to repay some or all money whether contingent or not; or (b) requiring the borrower not to repay for ten years or more; or (c) repayment of a loan which is in substance secured solely against assets employed in the arrangement.

<sup>131</sup> Sections GB 45 to 48 ITA 2007. Essentially, the provisions apply where there is a promoter of an arrangement where investors have a net loss for a period and limited recourse borrowings fund 50 percent or more of the net assets and the net assets consist of less than 70 percent tangible property (ie, land/building/plant), 10 percent or less of shares in listed corporations (portfolio holdings), shares in corporations holding non-resident corporation shares or employee shares.

<sup>132</sup> A Smith and D Dunbar, "Tax Avoidance Schemes in New Zealand: Limited Recourse Loans and the Deferred Deduction Rule", (Paper delivered at the 17th Annual Australasian Tax Teachers Association Conference, hosted by Victoria University of Wellington, 26-28 January 2005), p 13.

<sup>133</sup> AMC Smith and DG Dunbar, "Tax Avoidance Schemes in New Zealand: Limited-Recourse Loans and the Deferred-Deduction Rule", (2005) Vol 59:6 *Bulletin for International Fiscal Documentation* 249, p 254.

<sup>134</sup> *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC).

<sup>135</sup> See n 133, p 254.

<sup>136</sup> DG Dunbar, "The Privy Council Approach to Film Investments, Limited Recourse Loans and New Zealand Anti-Avoidance Legislation", (2005) Vol 11 *Asia-Pacific Tax Bulletin* 379, p 393.

<sup>137</sup> Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), p 35.

made by the member at the time the relevant contribution is made or agreed to be.<sup>138</sup> The submissions made against excluding limited recourse financing clearly have been persuasive.<sup>139</sup>

The ability of a taxpayer's legal relationships to alter risk is also highlighted in recent proposed amendments to the deferred deduction rules that seek to address the use of financial leases that substantially alter risks and rewards of owning an asset to a person who is not the lessor. However, this amendment has restricted application as it applies to assets used outside New Zealand.<sup>140</sup>

In the United States, such a non-recourse or limited recourse borrowing by a member to contribute equity appears to allow for an increase in the membership cost basis and, therefore, greater utilisation of losses. However, this is then reversed by the application of another loss restriction rule, the 'at risk rule'.<sup>141</sup>

The author would argue that measures should be introduced in New Zealand to address the use of limited or non-recourse borrowings to increase a membership cost basis, when overall there is no increase in the member's financial exposure.

## 5.5 Illustration of Membership Cost Basis

The following example, Example 2, demonstrates a wide variation in the measurement of the membership cost basis, and therefore the ability of members to utilise allocated losses between the transparent companies. This varies from \$58,000 for New Zealand's limited partnership and the United States' LLC, to \$18,000 for a United States' S Corporation, with no membership cost basis restriction at all for a New Zealand LAQC. It should be noted that the application of other loss restriction rules could reduce this variation. The variation between the S Corporation and the LLC treatment is due to the permitted inclusion of the outside loan for the LLC members.

### Example 2: Membership Cost Basis Rules

Assume the following:

- Cooper has contributed \$10,000 cash as equity to the transparent company;
- The transparent company has borrowed \$40,000 from a third party (outside loan) for which Cooper has provided a personal guarantee;
- Currently, the transparent company has allocated income to Cooper of \$5,000 which has not been paid (unpaid allocation);
- Cooper has borrowed \$3,000 to contribute further equity to the transparent company on a limited recourse basis. Only Cooper's membership interest in the transparent company stands as security for the repayment of this limited recourse borrowing.

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<sup>138</sup> The new s HG 11(5) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 11(4)(a) in the August Bill).

<sup>139</sup> New Zealand Institute of Chartered Accountants, *General and Limited Partnerships: Proposed Tax Changes – Submission on the Government Discussion Document*, (Wellington, 25 August 2006), p 14. The Institute questioned the need for the Government to intervene when the loan is from an arm's length lender willing to make funds available on a non-recourse basis – since they take into account security, strength of proposal, rate of return and reputation.

<sup>140</sup> Section FA 11 ITA 2007.

<sup>141</sup> Section 465(b)(2) IRC 1986 (US): for a taxpayer to be at risk, the taxpayer must have a personal liability for the repayment or have property (outside the activity) as security, and s 465(b)(4) non-recourse financing excluded from amounts at risk.

Cooper's membership cost base pursuant to the jurisdictions and transparent companies discussed above are:

Description	S Corp	LLC	LAQC	NZ New Limited Partnership
Member equity cash contribution – \$10,000	\$10,000	\$10,000	NA	\$10,000
Outside loan – \$40,000	Nil	\$40,000	NA	Nil
Member guarantee – \$40,000	Nil	Nil	NA	\$40,000
Unpaid allocation – \$5,000	\$5,000	\$5,000	NA	\$5,000
Limited recourse borrowings – \$3,000	\$3,000	\$3,000	NA	\$3,000
<b>Total membership cost basis</b>	<b>\$18,000</b>	<b>\$58,000</b>	<b>NA</b>	<b>\$58,000</b>

## 6.0 RISK RULES

Both New Zealand and the United States have loss restriction rules that consider the level of a member's risk exposure; however, they operate very differently. In addition to measuring membership cost basis, the United States has an 'at risk rule' to determine the availability of allocated losses. The 'at risk rule' aims to restrict the use of allocated losses to members' economic risk, which may not be equivalent to the membership cost basis. In comparison, the New Zealand risk rule looks at whether the value of the membership interest in a LAQC is exposed to changes due to LAQC's losses.<sup>142</sup> This rule appears to be directed at an LAQC member reducing their risk exposure by holding a derivative, such as a put or call option, in relation to their membership interest to offset any reduction in value of the membership interest. If New Zealand's economic risk exposure rule is not satisfied, then any part of the loss allocated to that member is extinguished, as it is deemed not to be allocated and cannot be allocated to any other member, nor can it be carried forward by the LAQC.<sup>143</sup> Accordingly, for an LAQC member to utilise their allocated losses the value of their membership interest must be fully exposed to LAQC losses.

New Zealand's at risk rule has some important differences when compared to the United States rule. In the United States, the at risk rule applies to both S Corporations and LLCs, and takes into account the limited liability protection provided to members by the business form, as well as whether or not borrowings are of a recourse nature. In the United States, a member's at-risk amount equals the sum of:

- The cash or the adjusted basis of non-cash property contributed to the business; plus
- Most recourse borrowings by the business for which the member has personal liability or has secured by property not connected with the business; plus

<sup>142</sup> Section HA 27 ITA 2007. The rule is not satisfied if the LAQC's losses result in a reduction in the value of the membership interests in the LAQC and a member suffers no, or almost no part, of any such reduction. For example, because of any factors, such as the right of a member over any other person to sell any thing or any right of any other person to require the member or other person to sell any thing.

<sup>143</sup> Section HA 27 ITA 2007.

- The member's share of amounts borrowed for use in the business that are qualified non-recourse financing,<sup>144</sup> and
- The member's share of allocated income items.<sup>145</sup>

This calculation is then decreased by any actual distributions to the member, the member's share of allocated (and deducted) loss items, and the repayment of loans that had earlier increased the member's at risk amount.<sup>146</sup> In determining this at risk amount, non-recourse borrowings and guarantees provided by members are excluded.<sup>147</sup> However, the real estate industry in the United States is given some concessional treatment due to the definition of 'qualified non-recourse financing'.<sup>148</sup>

The operation of the at risk rule excludes an LLC's outside loans from increasing a member's access to losses,<sup>149</sup> because the LLC's creditors would only have recourse against the LLC.<sup>150</sup> The member guaranteeing the outside loan does not alter this lack of risk exposure by the member, since the guarantor-member of the S Corporation or the LLC would have a legal right to reimbursement against the transparent company upon fulfilling the guarantee. Such a reimbursement right reduces the members' risk exposure.<sup>151</sup> Also, the at risk rule would exclude limited recourse borrowings secured over the membership interest from increasing the amount of losses that could be utilised.

The differences mean that New Zealand's at risk rule does not prevent the utilisation of losses in excess of the member's equity investment in the LAQC or their financial exposure.<sup>152</sup> Instead, New Zealand's at risk rule only requires a member to be exposed to a potential decrease in value of their membership interest due to the LAQC incurring losses. Provided there are no derivatives held in relation to the LAQC membership interest, losses could be utilised by members. This result is different from that in the United States, which caps the utilisation of losses through the combined effect of the membership cost basis and the 'at risk rule'.

The new limited partnership regime does not include a separate at risk rule, with only the membership cost basis rule determining a member's potential to utilise allocated losses.<sup>153</sup> The deferred deduction rule previously discussed could have some implications, although it is restricted to the

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<sup>144</sup> Section 465(b)(6) IRC 1986 (US). Qualified non-recourse financing is where a business has non-recourse debt collateralised with real property it uses in its business. This is because real estate non-recourse financing provided by a bank, retirement plan, or similar party or by a Federal, state, or local government generally is deemed to be at risk.

<sup>145</sup> Sections 465(b)(1) and (2) IRC 1986 (US).

<sup>146</sup> Section 465 IRC 1986 (US).

<sup>147</sup> Section 465(b)(4) IRC 1986 (US).

<sup>148</sup> Section 465(b)(6) IRC 1986 (US).

<sup>149</sup> Unless the member has a personal liability for its repayment: ss 465(b)(1) and (2) IRC 1986 (US).

<sup>150</sup> The members' limited liability protection would prevent the creditor from satisfying the debt out of the personal wealth of the LLC members. MP Altieri and WJ Cenker, "Partnerships, LLCs, LLPs and S Corporations", (2002) Vol 72:10 *The CPA Journal* 40, p 47. Compared to general partnerships, where members have joint liability for outside loans.

<sup>151</sup> MP Altieri and WJ Cenker, "Partnerships, LLCs, LLPs and S Corporations", (2002) Vol 72:10 *The CPA Journal* 40, p 47.

<sup>152</sup> This conclusion is supported by the example given in Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006).

<sup>153</sup> The new s HG 11 ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 11 in the August Bill).

limited recourse financing of intangible property investments.<sup>154</sup> There appears to be no current consideration of whether a member does have financial exposure when non-recourse or limited recourse borrowings are used to fund equity contributions. However, there is some acknowledgment of financial exposure, as the membership cost basis rule largely only applies to limited members and not to general members of the new limited partnership.<sup>155</sup> While the November Bill has slightly extended the at risk rule to general members when there has been switching in membership status, it still acknowledges that general members have liability exposure.<sup>156</sup>

Example 3 below illustrates the impact of the at risk rules in New Zealand and the United States. Similar to the results in Example 2, it can be observed that there is still variation between the United States and New Zealand after applying these rules. Indeed, the New Zealand figure of \$58,000 has not altered for the new limited partnership, whereas there is an alignment between S Corporations and LLCs.

### Example 3: Risk Rule Operation

Refer to the facts for Example 2, now also applying the jurisdictions' at risk rules.

Cooper's risk amount would be as follows:

Description	S Corp	LLC	LAQC	NZ New Limited Partnership
Member cash contribution – \$10,000	\$10,000	10,000	NA	\$10,000
Outside loan – \$40,000	Nil	Nil	NA	Nil
Member guarantee – \$40,000	Nil	Nil	NA	\$40,000
Unpaid allocation – \$5,000	\$5,000	\$5,000	NA	\$5,000
Limited recourse borrowings – \$3,000	Nil	Nil	NA	\$3,000
<b>At risk amount</b>	<b>\$15,000</b>	<b>\$15,000</b>	<b>NA</b>	<b>\$58,000</b>

What is of concern for New Zealand is the large difference between the new limited partnership regime and the transparent companies in the United States. This difference is due to member guarantees and limited recourse borrowings allowing greater utilisation of losses in New Zealand. This differential would have been further increased if unrealised capital gains were also included in the membership cost basis.<sup>157</sup> The loss restriction rules for the new limited partnerships may further undermine the

<sup>154</sup> Sections GB 45 to GB 48 ITA 2007.

<sup>155</sup> Inland Revenue, *Limited Partnerships Bill: Commentary on Parts 5 and 6 of the Bill – Associated Tax Changes*, (Wellington, August 2007), p 17; and Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), p 39.

<sup>156</sup> Refer to the prior discussion about this issue in section 5 of the article.

<sup>157</sup> The inclusion of unrealised capital gains was a possibility raised in the Discussion Document, which was not subsequently implemented. Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), pp 35-36.



integrity of the New Zealand tax system. The author argues that New Zealand should consider excluding non-recourse borrowings and guarantees to determine a member's ability to use allocated losses.

## 7.0 PASSIVE RULES

In determining the utilisation of losses, the United States also distinguishes between whether a member is or is not active in the transparent company's business. If a member is not active in the business, then the losses are regarded as 'passive' and may only offset other passive income. While these passivity rules do not eliminate the losses allocated, they restrict what income the losses can offset. The quarantining of losses in this manner may prevent a member from the timely utilisation of losses if the member does not have sufficient passive income. This mechanism enables a government to protect tax revenue from taxpayers creating excessive passive losses, which may be easier to produce than active losses. This treatment of passive losses is a reversal of the concessional treatment that can be afforded to income from capital, such as reduced rates applying to capital gains and corporations. Such quarantining signals that a government is willing to give concessional tax treatment to positive economic activity that produces income, and is more reluctant towards negative economic activity.

The author would argue that these passivity rules may be important in maintaining the integrity of the tax system; however, they should have universal application to all taxpayers, not just to those investing through transparent companies. A passive rule may be desirable as there may be greater potential for the manipulation of passive income or losses. Such arguments underlie controlled foreign company (CFC) rules, which generally attribute passive income rather than active income.<sup>158</sup>

New Zealand does not impose any broad rules that distinguish between active and passive losses flowing through a LAQC to members, although, if an allocated loss is in respect of CFCs or foreign investment funds (FIF), it can only be offset against income of a similar nature.<sup>159</sup> Also, there was a rule for special partnerships that required forfeiture of tax losses if, in the same year, there was no New Zealand income.<sup>160</sup> The absence of any broad passivity rules is currently unlikely to alter with the introduction of the new limited partnership regime.

The United States applies passive loss rules to most taxpayers, including both S Corporation and LLC members.<sup>161</sup> The passivity rules are considered in addition to the membership cost basis and the at risk rule.<sup>162</sup> For losses allocated from a transparent company to be regarded as active in the United States, the member must have a material participation in the business on a regular, continual and

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<sup>158</sup> See subpart EX of the ITA 2007.

<sup>159</sup> Section HA 24 ITA 2007. Committee of Experts on Tax Compliance, *Tax Compliance: Report to the Treasurer and Minister of Revenue*, (Wellington, December 1998), Ch 6: Tax Mitigation, Avoidance and Evasion, p 26.

<sup>160</sup> Previously, s IE 1(2B) ITA 2004.

<sup>161</sup> The passive activity loss rules apply to individuals, a corporation in which five or fewer individuals own more than 50 percent of the membership interest or to corporations or a corporation engaged in rendering certain professional services and in which the employees of the corporation own more than 10 percent of the membership interest: s 469(a)(2) IRC 1986 (US).

<sup>162</sup> There are three categories of income: active, passive and portfolio. Portfolio income refers to annuity income, interest, dividends, guaranteed payments from a partnership for interest on capital, royalties not derived in the ordinary course of a trade or business, and gains and losses from disposal of investment assets: s 469 IRC 1986 (US). If the transparent company's allocated losses are categorised as passive, the member can only offset them against passive income. For example, losses from rental activities would be regarded as passive losses.

substantial basis.<sup>163</sup> There are a number of tests to determine whether the member has material participation, including a need to participate in the activity for more than 500 hours during the taxable year (being approximately 10 hours per week for a 50-week working year).<sup>164</sup> If members of an S Corporation or an LLC actively participate in the transparent company's business activities, any losses would be regarded as active. Given the nature of a closely-held business, especially if a member-management approach has been adopted, then the active participation may be present, and the losses freely available. However, such active participation by members may have adverse consequences for the overall tax burden, given the application of payroll taxes in the United States. If regarded as passive, then the transparent company losses allocated to members would be quarantined for offset only against passive income of the member.<sup>165</sup>

It is important to recognise that with S Corporations, LLCs and LAQCs the involvement of a member in management does not of itself have adverse implications on the member's limited liability protection.<sup>166</sup> In contrast, a limited member of the new limited partnership could lose their liability protection if actively involved in the business.<sup>167</sup> This governance characteristic is an important consideration in arguing for the retention of the LAQC regime even with the introduction of the new limited partnership regime and is explored later in this article in section 9.

To illustrate the differences between the jurisdictions, Example 4 below details the application of the passivity rules to the transparent companies discussed here.

#### **Example 4: Passivity Rules**

Refer to the assumptions given in Example 2, with the following additional scenarios:

- The member is actively engaged in the business for approximately 30 hours per week ('active member'); and
- The member has little involvement in the business (approximately one hour per week) ('passive member').

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<sup>163</sup> Section 469 IRC 1986 (US).

<sup>164</sup> Regulation 1.469-5T(a) Treasury Regulations (US). Alternative tests are: (a) devoted greater than 500 hours to the LLC's activity in five out of the ten preceding years, or (b) devoted greater than 500 hours to the activity for any three preceding years and the activity involves the rendition of personal services.

<sup>165</sup> However, in any one year, individuals can offset up to \$25,000 of passive losses from rental real estate against active and portfolio income: s 469(e)(1) IRC 1986 (US).

<sup>166</sup> Of course, in this capacity the member may be exposed to certain duties which, if breached, exposes the member to liability.

<sup>167</sup> Clauses 18(1), 26 and 27 Limited Partnerships Bill 2007 (November).

Description	S Corp	LLC	LAQC	NZ New Limited Partnership
Active member	Available <sup>#</sup>	Available <sup>#</sup>	NA	NA – but may adversely affect liability protection
Passive member	Quarantined <sup>*</sup>	Quarantined <sup>*</sup>	NA	NA

Key:

#: Subject to membership cost basis and at risk rule.

\*: Subject to membership cost basis and at risk rule and quarantined for offset against passive income only.

## 8.0 STREAMING RULES

Another integrity measure that has been introduced in conjunction with transparent companies is a series of rules dealing with the ability to stream losses to some members in preference to others. In any year, the ability of members to utilise allocated losses (or other tax preferences) may vary due to their specific tax profile. For example, a transparent company with losses may have two members, Cooper and Jodi. Cooper will have no other income for three years, whereas Jodi will have substantial other income. In these circumstances, there will be a tax greater benefit if the losses for the first three years are allocated only to Jodi, who can immediately utilise them.<sup>168</sup> In comparison, Cooper would have to wait three years to utilise any allocated losses. The allocation of losses (or income) according to a member's tax profile is referred to as 'streaming'.<sup>169</sup> Streaming may be seen as infringing the integrity of a tax system because it facilitates exploiting losses and tax preferences. An alternative view is that streaming enables the most effective utilisation of resources between members.

In New Zealand and the United States, there are a number of mechanisms to restrict the streaming of losses from transparent companies. These include the initial eligibility requirements for transparency and special allocation rules.

The LAQC and S Corporation eligibility requirement for only one class of membership interest reduces the ability to stream.<sup>170</sup> This requirement means that each membership interest must have the same entitlement to the allocation of profit and/or losses from the transparent company.<sup>171</sup> However,

<sup>168</sup> Of course, this depends upon Jodi being able to satisfy any loss restriction rules that might operate in the relevant jurisdiction.

<sup>169</sup> There are a number of factors that could affect a member's ability to utilise allocated losses, such as their membership cost basis, their at risk amount, whether the member is active or passive in the business, and whether the member is a tax resident or not. For further examples of streaming; see Inland Revenue, *Officials' Report on Parts 5 and 6 of the Limited Partnerships Bill: Tax Aspects*, (Wellington, November 2007), p 6.

<sup>170</sup> In the United States, s 1361 IRC 1986 (US). In New Zealand, s HA 10 ITA 2007. Although S Corporations are slightly more flexible in determining 'one class', allowing for variations in members' voting rights: s 1361(c)(4) IRC 1986 (US).

<sup>171</sup> With an S Corporation, each item of income, losses, deductions and credits is allocated pro-rata to members on a per membership interest per day basis: s 1377(a)(1) IRC 1986 (US). Similarly, LAQC losses are allocated to members in ratio of the number of shares held by all members during an income year on a per share, per day basis, known as their 'effective interest': s HA 24 ITA 2007. Also, in relation to income, New Zealand essentially has a streaming rule as any dividend payment must be imputed to the fullest extent possible by the LAQC: s HA 15 ITA 2007. This is an anti-streaming rule to avoid dividends being directed to members dependant on their tax profile.

the author argues that the requirement for one class of membership interest does not entirely eliminate the potential for streaming. Streaming could occur by issuing more membership interests to members best able to utilise losses. For this strategy to be effective, the membership interests would have to be issued at the beginning of the loss year, and not part way through or at the end of the year when it becomes apparent that a tax loss will be generated.<sup>172</sup> Additionally, the payment of reasonable wages and other expenses to members could be used to manipulate the overall allocation of losses.<sup>173</sup>

The New Zealand Government appears to be eager to restrict the ability of streaming with the new limited partnerships.<sup>174</sup> This is illustrated by the rule that income, expenditure, losses and other items will be allocated to members in the same proportion determined by the member's share in the partnership income.<sup>175</sup> Also, the 60-day rule as part of the membership cost basis rule prevents members artificially inflating their cost basis temporary at year end and then quickly reducing it in the following year.<sup>176</sup>

In contrast to S Corporations and LAQCs, the LLC does not require the same class of membership interest for transparency to apply. All that is required is for the LLC to meet the requirements for a Check-the-Box election.<sup>177</sup> This means that the LLC's Operating Agreement<sup>178</sup> can allow for special allocations<sup>179</sup> of income, deductions, losses or tax credits to different members.<sup>180</sup> However, for special allocations to be recognised for United States' tax purposes they must satisfy the 'substantial economic effect rule'.<sup>181</sup> This is a two-part test requiring an allocation to have 'economic effect', and that it is 'substantial'.<sup>182</sup>

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<sup>172</sup> This is because a member's allocation is calculated on a per day basis of the year.

<sup>173</sup> For example, if one member were paid wages or lease payments by the LAQC, this would effectively allocate more profit to this member, resulting in less profit in the LAQC to be allocated amongst members.

<sup>174</sup> Inland Revenue, *Limited Partnerships Bill: Commentary on Parts 5 and 6 of the Bill – Associated Tax Changes*, (Wellington, August 2007), p 2.

<sup>175</sup> The new s HG 2(2) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 2(2) in the August Bill). Inland Revenue reported that it should be made clear that the rule applies to 'losses', which now appears in the November Bill: see n 169, p 10.

<sup>176</sup> The new s HG 11(9) ITA 2007, inserted by the Limited Partnerships Bill 2007 (November) (s HD 11(4)(e) in the August Bill). Refer to the prior discussion about the membership cost basis rule in section 5 of this article.

<sup>177</sup> Since 1997, an LLC can simply 'Check-the-Box' for transparent tax treatment. Technically by default, a multi-member LLC would be classified as a general partnership: reg 301.7701-2(c)(1) and (2) Treasury Regulations (US). A single member LLC for tax purposes can be classified as a corporation, an association, or can elect for the LLC to be disregarded as an entity separate from its owner: s 301.7701-3 IRC 1986 (US). In the latter circumstance, the single member LLC is taxed as a sole proprietor rather than as a general partnership if it is not a state corporation, publicly traded entity or a certain foreign business form.

<sup>178</sup> Section 704(a) IRC 1986 (US).

<sup>179</sup> For example, special allocations could allow for capital gains or depreciation deductions to be allocated disproportionately to one member whose tax profile results in a more effective utilisation of them: HM Friedman, "The Silent LLC Revolution – The Social Cost of Academic Neglect", (2004) Vol 38:1 *Creighton Law Review* 23.

<sup>180</sup> In addition, there are regulations to restrict 'shifting tax consequence rule' for foreign members: reg 1.704-1(b)(2)(iii)(b) Treasury Regulations (US).

<sup>181</sup> Section 704 IRC 1986 (US). The 'substantial economic effect' is elaborately defined in the regulations promulgated: reg 1.704-1 Treasury Regulations (US). If an allocation lacks substantial economic effect, then it is modified to conform to the economic arrangement.

<sup>182</sup> Essentially, this rule requires that there be economic impact associated with the allocation.

For the ‘substantial economic effect’ rule to be satisfied, the LLC Operating Agreement must, among other things, unconditionally oblige any member with a deficit in a capital account to restore the deficit upon the liquidation of the LLC, or when the member leaves the LLC.<sup>183</sup> This unconditional obligation adversely impacts on the member’s limited liability protection.<sup>184</sup> Accordingly, if LLC members want unrestrained special allocations, they forgo complete liability protection. The regulations allow an alternative if LLC members want to retain their limited liability and allow for special allocations, provided no deficit is created in a member’s capital account.<sup>185</sup> This essentially means that special allocations are restricted to the amount of members’ capital account, which is similar to membership cost basis.<sup>186</sup>

In the author’s opinion, streaming rules may be superfluous in the presence of an adequate membership cost basis rule that takes into account a member’s economic risk.<sup>187</sup> Rules that try to restrict streaming may add undue complexity to the tax system compared to the revenue at risk. Furthermore, an added benefit of streaming is that it could assist closely-held businesses in addressing their financing problem by reducing members’ overall tax liability.

## 9.0 REPEALING LAQCS?

The prior analysis has demonstrated that compared to the rules established in the United States, New Zealand’s regime for the utilisation of LAQC losses is minimal in content. The main rules that restrict the utilisation of LAQC losses are the requirements for one class of membership interest<sup>188</sup> and the value of the LAQC membership interest being exposed to change because of losses generated by the LAQC.<sup>189</sup> Other rules that may influence the utilisation of losses are the deferred deduction rule and the anti-avoidance eligibility requirement.<sup>190</sup> However, they are of limited or uncertain application in terms of allocated LAQC losses.

Overall, the author would argue that the New Zealand rules applying to LAQCs losses are inadequate to ensure the integrity of the tax system is maintained. This is because with the availability of LAQC losses, the tax system could be distorting investment decisions. One of the concerns with providing tax

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<sup>183</sup> Regulation 1.704-1(b)(2)(ii)(b) Treasury Regulations (US). The other things the Operating Agreement must specify for substantial economic effect to exist are: (a) the maintenance of a capital account for each member pursuant to the rules set forth in the regulations; (b) allocations of tax items be reflected in those accounts; and (c) LLC assets be distributed amongst members upon liquidation of the LLC based on the members’ capital account.

<sup>184</sup> JL Kwall, *The Federal Income Taxation of Corporations, Partnerships, Limited Partnerships, Limited Liability Companies, and their Owners*, (New York, Foundation Press, 2005), p 161.

<sup>185</sup> Regulation 1704-1(b)(2)(ii)(b),(d) Treasury Regulations (US). An alternative test provided by the regulations is if the LLC Operating Agreement includes a “qualified income offset”, the Operating Agreement must provide that: (a) capital accounts will be maintained in accordance with the regulations; (b) allocations of tax items be reflected in capital accounts; (c) liquidating distributions be made in accordance with positive capital account balances; and (d) no deficit may be created in a member’s capital account and, if one is inadvertently created, the member must be allocated gross income in order to eliminate it as quickly as possible.

<sup>186</sup> Also, for the ‘substantiality’ requirement to be satisfied the allocation at issue cannot be offset by another allocation in the same or later year: reg 1.704-1(b) Treasury Regulations (US).

<sup>187</sup> While streaming may enable the timelier utilisation of losses, these will be restricted to the membership cost basis.

<sup>188</sup> Section HA 10 ITA 2007.

<sup>189</sup> Section HA 27 ITA 2007.

<sup>190</sup> Section HA 12 ITA 2007. The final additional eligibility requirement is that none of the shares has been subject to an arrangement for making the QC and LAQC election to defeat the intent and application of the LAQC regime.

transparency to a business form with limited liability is that members will not take account of the full cost and impact of their business operations due to their restricted personal financial exposure. This failure to take account of all external costs may lead to artificially inflated profits, and may result in investments being undertaken that otherwise would not occur.<sup>191</sup>

Example 1 above illustrated the returns that can be generated through the claiming of tax losses. In this scenario, the tax system can act as a 'reverse externality', in the sense that it artificially inflates returns and potentially distorts investment decisions. It is for this reason that governments need to ensure that appropriate loss restriction rules apply when a tax transparent company form is available to taxpayers. The New Zealand Government acknowledged this potential in 2006.<sup>192</sup>

"[The] ... absence of loss limitation rules is likely to distort efficient risk-bearing decision-making and efficient resource allocation by encouraging investors to enter arrangements or schemes whereby small amounts of capital are invested to get access to larger net losses. This could result in abuse ... [and] ... may potentially create large fiscal costs to the government."

It appears that the Government may have realised this issue too late after establishing its LAQC regime in 1992. The lack of appropriate loss restriction rules may have generated the potential for a 'large fiscal cost' to the Government. In 1994, there was already \$200 million worth of losses flowing through LAQCs, and by 1998 this had increased to \$365 million.<sup>193</sup> It should be recalled that the potential size of this leakage was explicitly illustrated in the *Accent Management* case.<sup>194</sup>

However, it is the author's view that this does not necessarily lead to the conclusion that the repeal of the LAQC regime is necessary. The current New Zealand Minister of Finance, Dr Michael Cullen, has previously stated it is the "inappropriate use of the LAQCs", rather than the LAQCs themselves, that need to be focused on.<sup>195</sup> Indeed, looking closely at the *Accent Management* case while LAQCs were used in the scheme it is argued that they were not critical for its operation; more essential were the contractual terms, non-recourse loans and the use of a charitable trust.<sup>196</sup> Instead of repealing the LAQC regime, the integrity of the New Zealand tax system could be improved by the introduction of a broad financial exposure rule applying to the use of all losses in New Zealand. Such a rule would apply to all business forms, including LAQCs and the new limited partnerships.

In determining the structure of such a broad financial exposure rule, the author argues that the membership cost basis rule proposed for the new limited partnership is deficient. The concerns that the author has with the rule involve the inclusion of member guaranteed amounts, and the ability for non-

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<sup>191</sup> In that if all the true costs of the activity were included, it might outweigh the income to be generated, or result in a return lower than other avenues.

<sup>192</sup> Inland Revenue, *General and Limited Partnerships - Proposed Tax Changes: A Government Discussion Document*, (Wellington, June 2006), p 34.

<sup>193</sup> Refer to Figure 2.

<sup>194</sup> *Accent Management Ltd v CIR* (2005) 22 NZTC 19,027 (HC). DG Dunbar, "The Privy Council Approach to Film Investments, Limited Recourse Loans and New Zealand Anti-Avoidance Legislation", (2005) Vol 11 *Asia-Pacific Tax Bulletin* 379, p 393, suggesting that the potential size of loss of tax revenue in this case was greater than \$3 billion over a 50-year time frame.

<sup>195</sup> M Cullen, "Revenue Minister Speaks on Tax Matters", (Address to the Hawke's Bay Financial Planners and Insurance Advisors Association, 4 July 2003).

<sup>196</sup> See n 194.

recourse or limited recourse borrowings to increase equity contributions. Furthermore, there may be some benefit in quarantining losses according to a member's involvement in the business activity.

The author's conclusions have been reached by analysing the United States' rules. It is not argued that New Zealand should merely duplicate the United States' rules, because while the United States appears to have a comprehensive set of rules, they duplicate each other to some extent. This duplication may lead to an increase in complexity or excessive record keeping. For example, the United States' membership cost basis, at risk rule and substantial economic effect rule all appear to be addressing the one issue of restricting losses to a member's financial exposure in the transparent company. In the author's opinion, these three rules could be incorporated in the one holistic rule applying to all taxpayers, restricting the utilisation of losses to a financial exposure amount. It is such a holistic rule for which New Zealand should aim. Such a rule is needed not only for LAQCs, but also for the new limited partnership regime. Without it, the integrity of the New Zealand tax system could be further compromised with this new business form.

For the time being, it appears that the Government will not proceed with the repeal of LAQCs. However, if the repeal of the LAQC regime does proceed, it would affect approximately 100,000 businesses currently operating as LAQCs. Accordingly, the Government may find it necessary to have a phase-out period rather than an immediate removal of the regime. Given that the LAQC is only a partial loss transparent company, the major ramification of its removal would be the cessation of the flow through of losses and tax preferences to members. Prior to any repeal, there could be an increase in the disposals of capital assets and the subsequent payment of unimputed dividends (exempt) to LAQC members to pass through tax preferences; and the realisation of losses.

However, in the author's view there is an important reason to maintain LAQCs, which is that they have characteristics distinguishing them from the new limited partnerships. These differences means the retention of LAQCs is not a proliferation of transparent companies offering the same key features. First, even though both business forms are tax transparent companies, that is, providing limited liability and separate legal entity status with flow-through tax treatment, the actual governance framework of both forms are different. The LAQC is essentially a corporation whereas the new limited partnership has partnership principles forming its basis.<sup>197</sup> These two distinct governance frameworks may cater for different investors. Also, the new limited partnership does not allow for single membership, a characteristic of many New Zealand businesses. A limited partnership requires at least two members,<sup>198</sup> being the general and limited member, whereas New Zealand corporations are allowed to have only one member.

Furthermore, the new limited partnership may be unsuitable for active members, as their involvement in the business activities can impinge on their limited liability protection.<sup>199</sup> In such a circumstance, a limited member is liable as a general member to a person who deals with the limited partnership if, at that time the debt was incurred, the person knew that the member took part in management and believed on reasonable grounds that the member was a general member.<sup>200</sup> It was previously observed that liability protection is not impinged for an LAQC member active in the business.

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<sup>197</sup> Refer generally to the Limited Partnerships Bill 2007 (August).

<sup>198</sup> Clauses 8 and 20 Limited Partnerships Bill 2007 (November).

<sup>199</sup> Clause 26 Limited Partnerships Bill 2007 (November). The recommended safe harbour rules are to be outlined in Schedules.

<sup>200</sup> Clause 26 Limited Partnerships Bill 2007 (November).

In addition, because LAQCs are partial loss transparent companies, compared to full transparency, income is not automatically allocated to members. The new limited partnership regime will have both income and losses automatically allocated to members. This is important as income retained within a LAQC is subject to tax at 30 percent, compared to income allocations to individuals that are subject to marginal tax rates from 19.5 percent to 39 percent. The lower tax burden that LAQCs could facilitate with profits retained at the entity level may assist businesses in terms of financing their operations.<sup>201</sup>

## 10.0 CONCLUSIONS

The importance of a valid loss restriction rule is exemplified by the New Zealand experience, which has a generous regime for LAQC members utilising allocated losses. After 15 years of operation, this generosity is now jeopardising the existence of the LAQC regime, since it is considered a risk to the tax base. This article has demonstrated with reference to the United States' regime that there can be a number of restrictions on members' access to losses from transparent companies. These restrictions include membership cost basis, risk rules, passivity rules and streaming rules.

Concerns with the flow-through of losses are valid, as there should be restrictions on the utilisation of tax losses. Without adequate restrictions, the tax system may distort investment decisions. However, in the author's opinion, these concerns could be adequately addressed through the introduction of a single rule restricting the utilisation of tax losses for all taxpayers to a financial exposure amount, regardless of business form. The loss restriction rules for the new limited partnership regime, while an improvement on the LAQC rules, may be deficient. Furthermore, due to differences in the underlying governance regimes, the new limited partnerships are not just a mere duplication of LAQCs, since these two structures provide users with different tax characteristics.

One important limitation of this article is that, at the time of writing, the new limited partnership regime has yet to commence in New Zealand. Future research should examine its effectiveness and whether amendments to the regime will be necessary. Related to this is the Government's announcement that the continued existence of LAQCs is in need of review. The outcome of this review is unknown at the time of writing. Notwithstanding these limitations to the article, it is the author's view that through introducing the right boundaries the LAQC regime can be navigated through its troubled 'teen years' and can continue to be an important business form in New Zealand for many years to come.

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<sup>201</sup> However, it should be acknowledged that, when income levels are low, individual marginal rates might be preferable.