

# Changes Coming for Your Investment

## Introduction and Background

Material changes are coming for qualifying companies (QC's). You need to be aware of these changes, together with the actions we are taking on your behalf to ensure that the financial impact on your investment is not unreasonable. The changes represent both a threat, but as set out in this Report, they may also present an opportunity.

You are an Investor in one of the 44 investments we manage that are structured as partnerships of qualifying companies (QC's), specifically loss attributing qualifying companies (LAQC's). An LAQC is a limited liability company that meets the LAQC rules in the Income Tax Act 2007.

Your forestry investment makes losses during the 28 or so years preceding harvest, and then makes a taxable profit at harvest. A feature of the LAQC rules is that they allow losses to pass through for deduction against your annual gross income (or to be carried forward). The LAQC rules have been in operation for the last 18 years.

In the remainder of this Report, all references to the 'QC rules' are to be read as also being references to the 'LAQC rules'. Using the one reference simplifies the explanation.

## Budget Announcement

Tucked away in the detail of this years budget, the Government announced that it would replace the current QC rules, and instead make QC's subject to 'flow-through tax treatment' (FTTT). Therefore from 1 April 2011, although your investment will remain a QC it will be subject to the FTTT rules, assuming the enacting legislation has been passed.

In May, the Policy Advice Division of the Inland Revenue Department and the New Zealand Treasury, released an officials' issues paper entitled 'Qualify Companies: implementation of flow-through tax treatment'. A copy of this issues paper can be downloaded from the link [www.forestenterprises.co.nz/issuespaper.pdf](http://www.forestenterprises.co.nz/issuespaper.pdf), alternatively we can mail a copy if you telephone Forest Enterprises on 0800 746 346. The paper sets out the rationale for the budget announcement, and the consequential changes which will apply as a result of the implementation of the FTTT rules for QC's. Some of the consequential changes could have a materially adverse impact on your investment.

## Flow-Through Tax Treatment Rules

Under the FTTT rules, the investment vehicle itself is not taxed, instead each Investor is treated as if carrying on the activity of the investment vehicle and taxed accordingly. In our forestry investment context, under the FTTT rules, each Investor will continue to receive their share of the annual losses, and at harvest will receive their share of the harvest income, and pay tax at their marginal tax rate on this income.

Both tax rules produce the same tax outcome for the forestry losses preceding harvest, but not necessarily the same tax outcome for the harvest income. The FTTT rules will handle the taxing of harvest income from your investment(s) in a superior manner to the QC rules, although the financial outcome is immaterial for most Investors. The different tax treatment of harvest income under the FTTT rules is explained in further detail in Appendix 1.

The problems under the FTTT rules arise in the consequential changes.

## Consequential Changes for Transfers

A key consequential change under the FTTT rules arises in the taxation treatment of transfers. Currently you can transfer your investment by transfer of the company shares. Unless you are deemed to be a trader in shares, there is no tax consequence for you as the transferor (seller), nor for the transferee (the purchaser).



Under the FTTT rules, when a transfer occurs, there is a deemed disposition of your share of the underlying assets. In your forestry investment, this means there is a deemed disposition of your share of the trees/forest and the land. Of concern is the disposal of the trees, because of the special tax treatment that applies. As the transferor (seller) you must pay tax at your marginal tax rate on the sale of the trees, and the transferee (purchaser), does not get a tax deduction for the same tree value, instead they get a 'cost of timber'.

A 'cost of timber' is a deduction equal to the tree value to carry forward for eventual deduction against future income from the transfer/sale/harvest of the trees. The value of a 'cost of timber' to the purchaser is much less than an immediate tax deduction, hence the amount the purchaser is prepared to pay is less. Under the FTTT rules, the transfer (sale) value to you after the tax you must pay, is less than the value at present under the QC rules.

However, the FTTT rules include a \$50,000 transfer value under which a transfer can occur with no tax consequences. This is called the \$50,000 de-minimis. Calculating whether a transfer falls within the \$50,000 de-minimis is determined by a prescribed formula in the Income Tax Act 2007. Further details on the formula are set out in Appendix 2.

There are also two other sections in the Income Tax Act 2007 which allow transfers with no tax consequence -

- a transfer pursuant to a Relationship Property Agreement, or
- a transfer to a close relative pursuant to death, when the close relative is related within two degrees.

## **The Threat - Other Events are Treated like Transfers**

Under the FTTT rules, a transfer arises when you transfer your investment to a party you nominate, or you sell your investment (and a transfer then occurs to that third party). In addition to these usual transfer events, the FTTT rules for QC's prescribe the following events to be treated like transfers, with the same negative tax consequences for the deemed disposal of the underlying trees –

- a QC ceasing to be a QC; or
- a QC electing not to be a QC; and

for these events there is no \$50,000 de-minimis i.e. the negative tax consequences always apply.

A QC ceases to be a QC when it breaches the compliance requirements. A breach of the compliance requirements occurs when certain actions are not taken within the prescribed timeframes following –

- a transfer; or
- the death of an Investor; or
- change of trustee of a trust that is an Investor; or
- the death of certain beneficiaries of a trust that is an Investor.

The Constitution of our QC's requires Investors to tell Forest Enterprises of these events in plenty of time, so that the compliance requirements can be met, and a breach avoided. In the event that an Investor fails to tell Forest Enterprises in time, and a breach occurs, the Investor responsible is required to make good the financial consequences on the other (innocent) Investors in the QC. This means the Investor responsible must pay the innocent Investors the financial cost of losing their tax deduction. Should the Investor fail to do so, the Constitution provides for the defaulting Investor's investment to be forfeited and the value of the forfeited investment used to reimburse the innocent Investors.

To date we have never had to take forfeiture action to reimburse innocent Investors. On the few occasions when a breach has occurred, we have successfully argued for the discretion available to

the Inland Revenue Department to be applied. Most important however is the fact that the financial cost of a breach under the current QC rules is comfortably within the market value of your investment(s). This means that innocent Investors would currently not suffer a financial loss (reduced financial return) as a consequence of a breach, in the event that the Inland Revenue Department did not apply their discretion.



Under the FTTT rules, the financial consequence of a breach, and the QC ceasing to be a QC, are substantially greater than under the present rules. Collectively, all the Investors in the QC are deemed to have sold the trees owned by the QC and must pay tax accordingly (at their marginal tax rates). Concurrently the Investors are deemed to have re-acquired the trees for which they receive a 'cost of timber'. The quantum of tax payable could well exceed the market value of the shares of the Investor responsible, leaving the innocent Investors with both a financial loss (reduced financial return), and also having to fund some of the tax payable. Forest Enterprises believes it is absolutely unacceptable for the innocent Investors to be exposed to this risk.

The second event to be treated like a transfer, is when a QC elects not to be a QC. Unlike the previous event, electing not to be a QC is within the control of Investors', however it has been our published intention to elect not to be a QC immediately preceding harvest. The consequence of doing so under the current rules is that the tax losses will remain within the investment for deduction against income derived by the investment. As the timing of electing not to be a QC was to coincide with harvest, the losses (the annual costs) will be able to be deducted against the harvest income, and as a result, there will be no negative financial consequences on Investors.

Under the FTTT rules, the financial consequence of electing out of the QC rules will be prohibitive. The Investors will each have to pay tax on their share of the market value of the trees deemed sold, and in return will get a 'cost of timber'. Because harvest is imminent, the market value on which tax will be calculated will be close to the projected return from harvest. However, as harvest has not commenced, Investors will have received no cash from the investment with which to pay this tax and would have to fund the tax from other personal financial resources. This would clearly be unacceptable to most (if not all) Investors. Forest Enterprises therefore believes it could not allow the QC's to elect not to be QC's preceding harvest.

The reason we currently intend to elect that the QC's not be QC's immediately preceding harvest, is so Trust Investors are not constrained by the QC dividend restrictions set out in Appendix 3.

## **Preferred Solution and Opportunity**

Forest Enterprises has lodged two submissions in response to the issues paper. In our first and substantive submission we have documented the material adverse consequences of the 'Other Events' that are to be treated like transfers discussed above. We have also documented the adverse consequences of a third change which is to make Investors in QC's associated persons. The consequence of this is that the tax status of one Investor could impact negatively on the tax treatment of a transaction for all Investors (in the same QC), reducing the financial return. We believe it would unacceptable to expose Investors to a potential financial loss (reduced financial return) arising in this manner. A copy of our first and substantive submission can be downloaded from the link [www.forestenterprises.co.nz/submission1.pdf](http://www.forestenterprises.co.nz/submission1.pdf), alternatively we can mail a copy if you telephone Forest Enterprises on 0800 746 346.

A key component of first and substantive submission is the solution we propose to overcome the unacceptable adverse consequences on your investment arising from the change to the FTTT rules. In brief, the solution is for the legislation needed to implement the change to include a transition option (without tax consequences), which will allow your existing partnership of QC companies to transition to a limited partnership. Your present shareholding in a QC company (that is a partner in a partnership), would transition to shares in one limited partnership for the same investment. Details on limited partnerships are set out in Appendix 4.

Having your investment as shares in one limited partnership would satisfactorily address most of the material adverse consequences identified, whilst still retaining the ability to pass through the annual tax losses, and also keeping the important limited liability protection for Investors.

Limited partnerships also operate under the FTTT rules, however they do not have the QC compliance requirements which can give rise to the unacceptable material adverse consequences of ceasing to be a QC (or electing not to be a QC). Also, Investors in a limited partnership are not associated persons.



Another important consideration (and the Opportunity) is that if the transition requested to one limited partnership for the same investment is provided for, there will be significant collateral benefits for Investors as follows –

1. The transition will achieve the amalgamation of the present multiple companies into one body, the limited partnership. Investors may recall that in 2005 we set out to amalgamate the multiple companies but were thwarted by legal and cost impediments. Consolidation into one investment entity simplifies the investment and this should translate into reduced costs in future years.
2. Exiting the QC rules also removes all of the present constraints on shareholders. The QC rules restrict who can be shareholders, and also how many persons can be shareholders in each QC (which restricts the minimum share parcel size in your investment to 200 shares). There are no such restrictions in a limited partnership. Having shares in a limited partnership would therefore give Investors much greater shareholding flexibility.

The downside of a limited partnership is the tax consequence under the FTTT rules, if the transfer does not arise from a Property Relationship Agreement, or pursuant to death to a close relative, and the calculated transfer value exceeds the \$50,000 de-minimis (as discussed earlier under the heading ‘Consequential Changes for Transfers’).

However, as limited Partnerships have no shareholder number restrictions (therefore no minimum share parcel size), Investors will have the choice to transfer a quantum of shares with a value within the de-minimis in any 12 month period (the time restriction in the de-minimis formula).

## **Minimum Alternative Solution**

In our second supplementary submission we have documented our minimum alternative solution. A copy of our second supplementary submission can be downloaded from the link [www.forestenterprises.co.nz/submission2.pdf](http://www.forestenterprises.co.nz/submission2.pdf), alternatively we can mail a copy if you telephone Forest Enterprises on 0800 746 346.

This solution requires changes to be made to the Income Tax Act 2007 so that the other events that are treated like transfers documented earlier are carved out. As a result, the deemed sale and purchase consequences would not arise. Under this option, the existing investment structure of a partnership of qualifying companies would continue unchanged, and most Investors would experience no effective change to their investment.

The downside of continuing with QC’s is the tax consequence under the FTTT rules, if the transfer does not arise from a Property Relationship Agreement, or pursuant to death to a close relative, and the calculated transfer value exceeds the \$50,000 de-minimis (as discussed earlier under the heading ‘Consequential Changes for Transfers’).

It is currently not clear how the de-minimis test will apply if Investors have multiple investment units in the same investment. What is known is that if the de-minimis is exceeded by the value of one investment unit, the tax consequences will arise if the transfer proceeds. If the de-minimis is exceeded only when the value of more than one investment units are combined, Investors will have the choice to transfer just one investment unit in any 12 month period (the time restriction in the de-minimis formula).

Under this option, the Investment should still be able to exit the QC rules before harvest so that Trust Investors are not constrained by the QC dividend restrictions set out in Appendix 3.



## Fall Back Position

The negative tax consequences of transfer under the FTTT rules, plus the material adverse consequences of the 'Other Events' that are to be treated like transfers, could all be avoided if your investment elects out of the present QC rules before 1 April 2011<sup>1</sup> (the implementation date for the change to the FTTT rules). This is the fall back position in the event that both the preferred and minimum alternative solutions are rejected.

The downside of electing out of the QC rules early would be the discontinuation of flow-through of tax losses. Instead, the annual tax losses would be trapped in the investment until harvest and this would have a negative financial impact for all Investors.

Exiting the QC rules will however remove all of the present constraints on shareholders. The QC rules restrict who can be shareholders, and also how many persons can be shareholders in each QC (which restricts the minimum share parcel size in your investment to 200 shares). These restrictions would no longer apply, therefore Investors will have much greater shareholding flexibility.

Exiting the QC rules will also retain the present taxation treatment of transfers. Unless you are deemed a trader in shares, there is no tax consequence for you as the transferor (seller), nor for the transferee (the purchaser).

## What Happens Now

The options available to Investors in response to the budget announced changes to the QC rules depend entirely upon whether one or other of the proposed solutions (preferred and minimum) requested in Forest Enterprises submissions are provided for in the implementing legislation. We believe the case for both options is compelling, however compelling or not, all that ultimately matters is what is expressed in the implementing legislation when passed later this year.

We will be vigorously pursuing this matter, which is extremely important for Forest Enterprises Investors, and will keep you fully informed during the process over the coming months.

What is certain is that if the implementation of the FTTT rules for QC investments proceeds as announced in the budget (and as detailed in the officials' issues paper), your investment will not be the same by the 1 April 2011 implementation date. The worse case scenario is that the only option available will be to elect out of the QC rules before 1 April 2011.

**S A R Wilton**  
**Managing Director**  
**Forest Enterprises Ltd**  
**23 July 2010**

## Please Note if Living Overseas

This Report reflects the consequences for New Zealand resident taxpayers. The consequences for someone like you not living in New Zealand may be different.

It is possible that 'flow through tax treatment' of the harvest income could have advantageous tax consequences for non residents, compared with dividends paid under the present rules.

We recommend you seek your own professional advice on the impact of the changes in your circumstances, but suggest you need not do so until the legislation is enacted, which will not be for some months (and we will let you know at the time).

Note also that the 0800 746 346 telephone number referred to only works in New Zealand. If you call from overseas, the number to use is +64 6 370 6360.

<sup>1</sup> Investments with a balance date other than March will have until the next balance date after 1 April 2011.



# Appendix I

## Different Tax Treatment of Harvest Income under the present Qualifying Company Rules and under the Flow-Through Tax Treatment Rules

### Tax Treatment under the Present Qualifying Company (QC) Rules

Under the present QC rules, income derived by the company from harvest is taxed like any company at the company tax rate. The company can then make a fully imputed dividend distribution to Investors, after deducting Resident Withholding Tax (RWT) so that the total tax paid is 33 cents in the dollar.

The Investor's share of the harvest income is therefore taxed initially at 33 cents in the dollar. If the Investor's marginal tax rate is less than 33 cents, the Investor must apply for a refund via their annual Tax Return. Under the Income Tax Act 2007, tax refunds are not payable from imputation credits. If an Investor is to get a refund, this can only be made from other tax paid such as RWT, PAYE and provisional tax.

In the event that the Investor has not paid (or paid insufficient) taxes from which a refund can be made, the refund balance carries forward to future tax years.

### Tax Treatment under the Flow-Through Tax Treatment (FTTT) Rules

Under the FTTT rules, no tax is paid by the investment, instead each Investor must pay tax (provisional and final) based upon their individual circumstances and their marginal tax rate. Therefore, the Investor always pays the correct tax on their share of the harvest income.

A further material benefit under the FTTT rules is the ability to spread the harvest income over the year of receipt, plus the preceding three tax years. This provides the opportunity to minimise the tax liability, and may offer a timing benefit.

# Appendix 2

## The \$50,000 de-minimis Formula

The \$50,000 de-minimis formula is found in section HG5 of the Income Tax Act 2007 and is expressed as follows -

$$\text{Disposal payment} + \text{previous payments in last 12 months} - (\text{gross tax value} - \text{liabilities}) - \$50,000$$

Disposal payment	The disposal payment is the higher of the transfer value, or the current market value, of the shares being transferred.
Previous payments in the last 12 months	The current transfer, plus all previous transfers in the last 12 months are counted, so even though the current transfer may not be exceed the de-minimis, the outcome using the sum of all transactions is what matters.
Gross tax value – liabilities	Gross tax value has a specific meaning in the Income Tax Act 2007. The effect of this portion of the formula is to deduct the pro-rata share of the balance sheet items like 'land cost', 'depreciated land development costs', depreciated value of improvements', 'cost of timber', after first deducting liabilities like borrowings.

The product of the 'gross tax value - liabilities' calculation only becomes of importance if the disposal payment total exceeds \$50,000.

Forest Enterprises has been working with this formula for transfers of shares in our older partnership investments since the flow-through tax treatment rules were introduced in 2008 (at the same time as the limited partnership legislation was enacted).



## Appendix 3

### Why it is Beneficial for Trust Investors not to be in a Qualifying Company at Harvest

It is a requirement of the current qualifying company (QC) rules that dividend income paid by a QC to trusts be –

- distributed to beneficiaries, generally within 6 months of receipt; and
- for the QC to remain a QC, the application of the shareholder rules to the beneficiaries to whom the dividend is distributed, cannot result in the 5 or fewer shareholder count being breached.

In Forest Enterprises investments, this means that the harvest return paid to trusts, and which must be distributed to beneficiaries of the trust, can only be distributed to beneficiaries related in the first degree. For example, parents plus children are collectively related in the first degree, whereas children on their own are not, nor are grandchildren related in the first degree to grandparents.

At the time of investment, all trust Investors received details on what this requirement means for their trust.

The significant downside of this requirement for trusts is that –

- the harvest return cannot be kept by the trust itself, and
- the trustees are not free to distribute the harvest return to the beneficiaries they may otherwise choose.

The issues paper on the QC change to the FTTT rules is silent on whether the distribution requirement to trusts will be retained. Forest Enterprises conclusion is that the requirement to distribute the flow through income to trust beneficiaries, and in a manner that preserves the 5 shareholder count maximum, will have to be retained. If it is not retained, the opportunity will be created to use trusts to exceed the 5 shareholder count maximum.

## Appendix 4

### Limited Partnerships

Limited partnerships are a product of the Limited Partnerships Act 2008 which came into force in May of 2008. The primary objective of the introduction of limited partnerships was to facilitate sustainable growth in New Zealand's venture capital and private equity industries.

Limited partnerships are a form of partnership involving a General Partner (who is liable for all the debts and liabilities of the partnership) and Limited Partners (who are liable to the extent of their capital contribution to the partnership – the same limited liability that arises in a company structure). In our forestry investment context, the Investors will be the Limited Partners and a special purpose limited liability company will be the General Partner.

The Limited Partners are restricted as to the partnership activities in which they can be involved. Forest Enterprises believes that there is a satisfactory way to structure a limited partnership so that Investors can continue to control the critical aspects of their forestry investment. We believe that the rights and obligations of the parties to the investment as currently structured via the partnership of multiple QC's can be replicated in a limited partnership structure.

Further details on the proposed operation of limited partnerships for our forestry investments will be advised if the transition option requested is provided.

Given the changes to the QC rules announced in the budget, Forest Enterprises has concluded that limited partnerships are now a superior forestry investment vehicle to our present partnership of QC's vehicle. We have however been prevented by the potential consequences arising from the Emissions Trading Scheme, plus the deemed disposal and re-acquisition ('cost of timber') taxation treatment of the sale and purchase of forests, from migrating our existing 44 QC investments to limited partnerships.

The transition option requested in our submission on the change to the FTTT rules, requires the setting aside of the deemed disposal and re-acquisition ('cost of timber') tax treatment.



