

Submission by

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Forest Enterprises Ltd

to the

The Policy Advice Division of the Inland  
Revenue Department

on the officials' issues paper on

**Qualifying Companies:  
implementation of flow-through tax  
treatment**

Mr S A R Wilton  
Managing Director  
Forest Enterprises Ltd  
P O Box 128  
MASTERTON 5840

Phone (06) 370 6367  
Fax (06) 370 6369  
Email [swilton@forestenterprises.co.nz](mailto:swilton@forestenterprises.co.nz)

**It is acceptable for Inland Revenue and Treasury officials to make contact with the author.**

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## **1. Summary of Major Points and Recommendations**

- 1.1. Forest Enterprises understands and accepts the rationale for the intended change to flow-through tax treatment of qualifying companies.
- 1.2. Implementation of flow-through tax treatment for qualifying companies will have unreasonable material adverse impacts on Forest Enterprises approximately 5,500 Investors.
- 1.3. The unreasonable material adverse impacts can all be satisfactorily addressed by providing a transition option allowing a qualifying company (and a partnership of qualifying companies) to transition to a limited partnership without a deemed disposition and reacquisition of the underlying forestry asset.

## **2. Forest Enterprises Use and Interest in Qualifying Companies**

- 2.1. Forest Enterprises' business is the co-ordination and on-going forest management and investment administration of *Pinus radiata* forestry investments for private individuals.
- 2.2. The nature of a forestry investment is that the investment makes losses for the approximately 30 years preceding harvest then makes a large taxable profit at harvest.
- 2.3. A loss attributing qualifying company allows the forestry losses for the approximately 30 years preceding harvest to be legitimately utilised by the shareholder Investors annually, rather than being retained within the company for deduction at harvest (at which date their value would be materially diminished, having accumulated over approximately 30 years).
- 2.4. In addition to flow-through of the tax losses, a qualifying company provides forestry Investors with the prudent and reasonable protection of limited liability that is only available within a company structure, or more recently if a limited partner within a limited partnership structure.
- 2.5. 44 of the company's managed forestry investments are structured as partnerships of multiple qualifying companies.
- 2.6. In total, 1,242 qualifying companies operate within the 44 investments.
- 2.7. All 1,242 qualifying companies are loss attributing qualifying companies.
- 2.8. The shares in these qualifying companies are owned by approximately 5,500 persons, of which approximately 20% are trusts.
- 2.9. The constitutions of our qualifying companies address the 5 or fewer shareholders restriction by specifying that the company has 5 share parcels of 200 shares (a total of 1,000 shares), and that the holder of each 200 share parcel must be 1 shareholder under the qualifying company count rules.
- 2.10. Forest Enterprises was an early adopter of the qualifying company rules with the first of the 44 investments structured with qualifying companies released by registered prospectus dated 9 October 1992.

- 2.11. Although our use of a partnership of qualifying companies was initially viewed with some scepticism within the Inland Revenue Department, our long standing track record over the last 18 years supports the statement that Forest Enterprises use of qualifying companies has not been considered problematic to the Inland Revenue Department.
- 2.12. The limited partnership rules are better suited to the style of our investments but have only been available since 1 April 2008, a date after the establishment of our 44 partnership of qualifying company investments.

### **3. Unreasonable Adverse Consequences from Deemed Disposal**

- 3.1. The change to flow-through tax treatment has material adverse consequences for our qualifying companies which have as a major underlying asset, a forestry asset.
- 3.2. These material adverse consequences arise because of the tax treatment of the disposal of a forestry asset which results in tax being payable by the Seller and the Purchaser deriving a Cost of Timber.
- 3.3. It is not the intention of this submission to argue the case against this tax treatment of the disposal of a forestry asset, instead the objective is to draw attention to the consequences in the context of implementation of flow-through tax treatment of qualifying companies, and to suggest an appropriate transition option solution.
- 3.4. The following two events are to be disposal events and give rise to the unreasonable material adverse consequence –
  - 3.4.1. one of our qualifying companies ceasing to meet qualifying company rules; and
  - 3.4.2. our qualifying companies electing out of the qualifying company rules.

### **4. First Unreasonable Adverse Consequence of Deemed Disposal**

- 4.1. The first material adverse consequence arises when one of our qualifying companies ceases to meet qualifying company rules.
- 4.2. Although the clear intention of the qualifying company rules was that they apply to closely held companies typically managed by the shareholders, the present rules in existence for 18 years have allowed companies that are closely held in number, but comprising shareholders unknown to one another and who do not manage the business, to satisfactorily operate as qualifying companies and own forestry assets.
- 4.3. Further, the rules have also allowed partnerships of multiple qualifying companies to operate during the same period of time and as noted earlier, Forest Enterprises manages 1,242 qualifying companies which own forestry assets.
- 4.4. The use of partnerships of multiple qualifying companies, not closely held plus managed by a professional manager, has been possible because the consequences of

failing to meet a compliance requirement, and therefore involuntarily ceasing to be a qualifying company, have been manageable.

- 4.5. When a qualifying company comprises shareholders unknown to one another, when there is a partnership of qualifying companies, and when that partnership of qualifying companies is managed by a professional manager, although the compliance requirements to keep valid elections in place is challenging, it is not impossible.
- 4.6. The compliance requirements are challenging because the professional manager is not closely involved with the shareholders therefore not aware of deaths, and other changes that require completion of replacement elections. The professional manager is reliant upon the shareholders themselves advising the manager within the prescribed time periods.
- 4.7. The current consequence of ceasing to be a qualifying company (in our case a loss attributing qualifying company), is the disallowing of all shareholders' deduction of the tax losses from the qualifying company from the tax year the company ceased to be a qualifying company.
- 4.8. This has been an acceptable consequence for our investments because we have provided in the constitution of the qualifying company that the shareholder responsible for the company ceasing to be a qualifying company is accountable to the remaining shareholders for their financial loss (additional tax payable). The Constitution also places the offending shareholder's own shares at risk of forfeiture to the benefit of the remaining shareholders if they do not make good the financial loss, and the value of their shares has always been sufficient to cover the financial loss.
- 4.9. With ceasing to be a qualifying company to be deemed a disposal and re-acquisition of the underlying assets, the forestry asset disposed and re-acquired results in tax being payable by all shareholders on the deemed disposal of the forestry asset and the same shareholders deriving a Cost of Timber.
- 4.10. The financial loss to each shareholder of this occurrence is substantial, and the total financial loss imposed on the shareholders not responsible will often exceed the value of the shares of the offending shareholder. The present forfeiture risk on the offending shareholder is therefore inadequate to protect the financial interests of the other shareholders.
- 4.11. Forest Enterprises believes it would be unacceptable to expose our Investors to a potential financial loss arising in this manner and their best interests will probably require electing out of the qualifying company rules before the implementation date of the flow-through tax treatment changes.
- 4.12. Electing out of the qualifying company rules will mean foregoing the present ability to deduct the annual losses in the years preceding harvest. The financial impact on Investors of not being able to deduct these losses will be material.
- 4.13. Forest Enterprises submits that this is an unreasonable consequence of the change to flow-through tax treatment of qualifying companies and notes that limited partners in a limited partnership (also with flow-through tax treatment) are not exposed to similar deemed dispositions.

## **5. Second Unreasonable Adverse Consequence of Deemed Disposal**

- 5.1. The second material adverse consequence arises when our qualifying companies wish to elect out of the qualifying company rules.
- 5.2. Unlike the first consequence which arises in an unplanned manner (a shareholder failing to advise the manager of a change requiring a replacement election), this consequence arises in a planned manner.
- 5.3. With electing not to be a qualifying company to be deemed a disposal and re-acquisition of the underlying assets, the forestry asset disposed and re-acquired results in tax being payable by all shareholders on the deemed disposal of the forestry asset and the same shareholders deriving a Cost of Timber.
- 5.4. It has been our published intention to elect out of the qualifying company rules before harvest to overcome the current restriction imposed on trusts which have to distribute dividend income to beneficiaries, and only to those beneficiaries related in the first degree such that the maximum of 5 shareholder count is preserved.
- 5.5. It is acknowledged that the issues paper identifies this practice as an opportunity to eliminate personal liability on the tax payable by the company.
- 5.6. Our published intention (none of our investments has reached harvest therefore none has distributed income) is not to eliminate personal liability on the tax payable by the company, instead it is to enable dividend distribution to a wider selection of trust beneficiaries.
- 5.7. It is also acknowledged that dividends are no longer to be paid by qualifying companies, therefore an initial conclusion is that the present provisions requiring distribution to beneficiaries, and in a manner that preserves the maximum 5 shareholder count to remain a qualifying company, will also be removed.
- 5.8. The issues paper is silent on this matter. Our conclusion is that the requirement to distribute the flow through income to trust beneficiaries, and in a manner that preserves the 5 maximum shareholder count, will have to be retained. If it is not retained, the opportunity will be created to use trusts to exceed the maximum 5 shareholder count.
- 5.9. In order to retain the pass through of annual forestry losses our companies must remain qualifying companies, however the effect of the tax consequence of electing out of the rules, immediately preceding harvest when doing so is a disposal, are material.
- 5.10. Tax will have to be paid on a forest value approaching the harvest sale value and the quantum of the tax payable will therefore be substantial. This tax will have to be paid before the cash from the harvest is available to fund it (and may not be available for a number of years, depending upon the timetable of the harvest program).
- 5.11. It is noted that the inequity of having to fund tax from a deemed disposition of a forestry asset when there is no cash available from the harvest, was addressed for close relatives with the addition of section FC 6.
- 5.12. The reality is that in order to meet the lawful expectation given to our trust qualifying company shareholders over the last 18 years, their best interests will probably require

electing out of the qualifying company rules before the implementation date of the flow-through tax treatment changes.

- 5.13. Electing out of the qualifying company rules before harvest will mean foregoing the present ability to deduct the annual losses in the years preceding harvest. The financial impact of not being able to deduct these losses will be material.
- 5.14. Electing out of the qualifying company regime will not be in the best interests of the majority of the Investors who do not hold their investment in a trust.
- 5.15. There is currently no conflict of interests as between the best interests of both these groups of Investors. The conflict only arises as a consequence of the implementation of the flow-through tax treatment.
- 5.16. Forest Enterprises submits that this is an unreasonable adverse consequence of the change to flow-through tax treatment.

## **6. Unreasonable Adverse Consequence of Associated Person Change**

- 6.1. The change to treat qualifying companies and their shareholders as associated persons has a material adverse consequence on our investments.
- 6.2. The rationale for the change expressed in clause 7 of the issues paper is that qualifying companies, unlike limited partnerships, are closely held entities with the shareholders typically managing the company, which is not the case with limited partnerships.
- 6.3. As set out earlier in this submission, Forest Enterprises partnerships of qualifying company investments are not closely held and are not managed by the shareholders.
- 6.4. It is acknowledged that this outcome was not the intention of the qualifying company rules, however the rules have been such that this arrangement has been a legitimate use of qualifying companies for the last 18 years.
- 6.5. Forest Enterprises believes it would be unacceptable to expose our Investors to a potential financial loss (additional tax cost) arising from the action/tax status of a fellow shareholder under the associated persons rules, and that their best interests will probably require electing out of the qualifying company rules before the implementation date of the flow-through tax treatment changes.
- 6.6. Electing out of the qualifying company rules will mean foregoing the present ability to deduct the annual losses in the years preceding harvest. The financial impact on Investors of not being able to deduct these losses will be material.
- 6.7. Forest Enterprises submits that this is an unreasonable adverse consequence of the change to flow-through tax treatment.

## **7. Unreasonable Consequences Addressed if Transition to Limited Partnership Allowed**

- 7.1. The material adverse consequences on Forest Enterprises Investors arising from the implementation of flow-through tax treatment of qualifying companies can all be satisfactorily addressed if the implementing legislation includes a transition option (without tax consequences) to limited partnerships.
- 7.2. Specifically, Forest Enterprises submits that a transition option should be allowed to enable transition from a qualifying company to a limited partnership, and also from a partnership of qualifying companies to one limited partnership.
- 7.3. In Forest Enterprises case, allowing the transition from a partnership of qualifying companies to one limited partnership would have the effect of replacing 1,242 qualifying companies and 44 partnerships with 44 limited partnerships.
- 7.4. The tax consequence which the transition would have to set aside would be the deemed disposal and re-acquisition of the underlying forestry asset which would otherwise result in tax being payable by all shareholders on the deemed disposal of the forestry asset by the qualifying company and the same shareholders deriving a Cost of Timber in the limited partnership.
- 7.5. The issues paper sets out the valid reasons for the changes to qualifying companies to make qualifying companies suitable only for a closely held entity with the shareholders typically managing the company.
- 7.6. As set out in this submission, Forest Enterprises has legitimately used partnerships of qualifying companies as it's investment vehicle and set up these investments prior to the existence of limited partnerships.
- 7.7. The issues paper sets out the key differences between limited partnerships and qualifying companies post implementation of flow-through tax treatment, and Forest Enterprises investments are without doubt best suited to the limited partnership rules.
- 7.8. Two transition options are currently possible without tax consequences arising from the disposal of the underlying forestry asset –
  - 7.8.1. transition to the new qualifying company rules discussed in the issues paper, and
  - 7.8.2. the defacto transition option out of the qualifying company rules prior to implementation of the flow-through tax treatment.
- 7.9. As documented in this submission, both of these options create unreasonable materially adverse consequences for our Investors compared with the status quo.
- 7.10. Providing a third transition option to a limited partnership without a deemed disposition and reacquisition of the underlying forestry asset (and one limited partnership for each of our partnerships of qualifying companies) will –
  - 7.10.1. transition our forestry investments to the most appropriate tax rules now available; and

- 7.10.2. will satisfactorily address all three unreasonable consequences that implementation of flow-through tax treatment for qualifying companies would otherwise impose; and
  - 7.10.3. would not undermine the tax base.
- 7.11. The tax base is not undermined because within the limited partnership rules the Forest Enterprises Investors will still be exposed to full flow-through tax treatment. All the transition to limited partnership rules achieves is the removal of the unreasonable consequences that will now arise within partnerships of qualifying companies that comprise shareholders unknown to one another who do not manage the company.
- 7.12. The limited partnership rules are deliberately drafted in such a way to avoid unreasonable consequences where the partners are not known to one another and where the investment is managed by a professional manager (the general partner).