

LAQC Changes and LTC's

What is happening?

LAQC's are going – the 2012 financial year is the first year of the new rules

History – began in 1990's to encourage investors to put more money into retirement savings

Reason for change – the idea that tax leakage was occurring as tax payers chose to use their higher individual marginal tax rate for losses, but when making a profit, tax at the lower company tax rate or change ownership to a Trust reducing rate from 38% to 33%.

Example of use of LAQC which IRD particularly doesn't like – flat owning company. This is an LAQC company which owns a house, and a shareholder of the LAQC lives in the house with other tenants.

The government's solution – LTC Look Through Company (But **IS** it the solution for you?)

Characteristics of LAQC

- Losses go to individuals, put against other income eg regular salary as an employee
- Profits – taxed in company at company tax rate (currently 28%) or taxed in individual's returns using shareholder salaries to transfer the profit.
- Note that the profits are treated in the same way as a normal company, but losses in a normal company must remain in the company.

Reasons for use of LAQC

- Rental properties – esp transfer home to LAQC & buy more upmarket for own use – ensures deductibility of interest claims
- Loss making companies
- Initial years of company start-up – prior to making a profit such as switching from partnership, restructuring business, changing livestock valuation scheme

IRD's solution is the removal of LAQC's and bringing in the LTC (Look Through Company) regime

Key features of LTC (Look Through Company)

- LTC is an incorporated company with limited liability
- In other respects, very similar to a partnership
- Shareholders are referred to as “Owners”
- For income tax, gains & losses are passed through to the owners, in proportion to their effective interest in the company
- No company tax rate – all income tax at owner’s marginal tax rate (ie individual or Trust)
- LTC does have obligations for other tax types (GST, FBT, PAYE)
- From the Income Tax rules, LTC’s are excluded from the definition of a company. There is no Imputation Credit account, and rules governing dividend payments are excluded.
- From the Companies Act perspective, LTC’s must comply with the regulations.

Advantages of using LTC

- Company structure but can make use of losses in individuals name
- Limited liability
- Profit & losses flow through (can be disadvantage)
- No FBT interest payable on overdrawn shareholders current accounts
- No need to declare dividend to get profit out

Disadvantages of LTC

- Profit flows through to individuals in proportion to shareholding – not able to make use of 28% company tax rate
- Shareholder count test – 5 shareholders only
- Owners contribution – may be insufficient, so losses not available to claim
- Owner’s contribution calculation – tedious.
- Difficult to know how much personal guarantee exists
- Cannot pay shareholder salaries at year end, need to pay wage with PAYE
- Working owners must have employment contract
- Share sales or disposals of property treated like a partnership and can result in tax payable (\$50k profit threshold and \$200k exemption for cost of depreciable property can eliminate this in many cases)

Criteria of LTC

- NZ Tax resident company
- Shares must be of the same class and voting rights to each owner
- Five or fewer look-through counted owners
- Not a flat owning company
- Owners (Shareholders) can only be trusts, individuals or another LTC (no ordinary companies)

Shareholder count test – although only five or fewer owners allowed, any owners within 2 degrees of separation are counted as one. Therefore a family situation is usually no problem. The problem can arise where shareholders are unrelated, or trusts are involved with unrelated beneficiaries.

Owner's loss limitation – Losses are only able to be claimed to the extent of investment the owner has in the company. The "Owner's basis" needs to be calculated each year to ensure losses are able to be claimed.

Owner's basis investment includes loans to the company, shareholders current account balance, income, capital gains and personal guarantees on company loans from the bank. Deducted from this is any money advanced to the owner, expenses by the company or losses which have already been claimed in previous years.

Usually a personal guarantee to the bank for the loan will be adequate to ensure losses are able to be claimed.

Problems can occur when children and parents are both shareholders, but parents provide the guarantee. Also friends where only one provides the personal guarantee, the other cannot continue to claim the losses.

Other considerations to take into account when deciding which entity to use

- the level of imputations in the company (Imputation Credit account balance)
- balances of shareholders current account.

There can be advantages for normal companies to become an LTC also.

Your Options

Do nothing – LAQC converts to a QC

- A QC is like a normal company except capital gains can be distributed tax free without winding up the company
- Losses accumulate in the company until it makes a profit.
- Profits can be taxed in the company or in individuals

Example – a farming company was made an LAQC initially as there were losses due to changes in livestock values. The company is now or soon will be a profit making company, so it no longer needs the loss attribution to the individuals.

Transition to a partnership or sole trader

- no limited liability
- no choice of where to tax profits – unable to make use of low company tax rate (currently 5% between company rate and top individual marginal tax rate)
- cost of switching to a different entity – legal costs, conveyancing costs to transfer land title and ownerships, transfer bank loans & new guarantees, accounting administration costs.
- possibility of bank not willing to renegotiate to refinance in these tough times
- a good option if tax losses are expected to exceed owners basis (economic investment in the company)

Example – rental property owned by 2 shareholders – only one has a personal guarantee and we still expect losses to occur. Remember we can no longer claim depreciation on the building.

Example – LAQC owning property - property slump means the asset backing guarantee is not sufficient to give full loss deductions.

Transition to an LTC

- Retain ability to make use of losses in individuals tax return
- Lose ability to tax profits at company tax rate of 28%
- No cost to transition – just file an election form signed by all shareholders
- No tax payable to change
- Retain company structure & limited liability

Example – Mum & Dad company, still making losses.

Example – If the company has large retained imputation credits, the profit relating to the Imputation Credits can be distributed to the shareholders tax free under an LTC, provided there are no capital reserves.

Example – If there is a large overdrawn shareholders current account FBT interest needs to be paid if a normal company. No interest payable in an LTC.

Transition rules and Timing

During the transition period there is no tax cost to change. This period ends six months after next year's balance date – ie there are 18 months to make the transition election.

To take effect for the current financial year, 6 months from balance date to elect – all shareholders must sign form.

If transferring to partnership/sole trader all change and transfer documentation must have taken place within 12 months or they will be taxed as a normal company. Change includes conveyancing, market valuations, bank debt organised, new guarantees etc.

Any queries, or if you would like any more clarification, or to meet individually, please contact

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