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LTC Company & Potential 'Fish Hooks'

Prior to 1 April 2011 a company set up as a Loss Attributing Qualifying Company (LAQC) could pass losses out to shareholders in proportion to shares held. The LAQC option allowed taxpayers to offset losses from their LAQC activity, with other income such as wages, and reduce income tax commitments.

In an attempt to reduce the tax benefits of LAQCs the Government introduced Look-through Company (LTC) legislation to apply from 1 April 2011. The aim of the new LTC regime was to limit the tax benefits to tax payers of the economic loss they suffered.

The new LTC regime appeared to be a logical alternative to the repealed LAQC structure, however as time has passed and the legislation is applied to situations, 'fish hooks' have surfaced. The consequences may not have been intended by the Government however as advisors we need to deal with them while awaiting legislation changes.

Some of the issues that we are aware of include:

- Depreciation Recoveries - Previously share transfers did not trigger depreciation recovery and potential tax costs. In certain instances share transfers in LTC companies can cause taxation payable with depreciation recoveries. Also, any revocation of the LTC status in the future will cause depreciation recovery.
- Loss of Corporate Tax Rate - LTC companies are good for passing losses out of the company to the shareholder, however profits are also distributed to the shareholders. Therefore the shareholder could end up paying 33% tax in their own name instead of the company rate of 28%.
- Limitations of Losses - With losses limited to the shareholders economic loss, losses generated by the company will not always be available to the shareholder. A detailed calculation needs to be completed each year allowing for such factors as shareholding, funds invested in the company and guarantees made.
- Share Transfers - Care is needed with share transfers to ensure part-year losses are not forgone, or tax triggered on depreciation recoveries.
- Salaries - Under an LTC, shareholder salaries need to be planned in advance and paid during the year.
- Loan guarantees - If a non-shareholder guarantees the company, this potentially limits the loss allocation available to the shareholders.
- Ceasing to be an LTC - The company will cease to be an LTC if the number of shareholders increases to over five. Therefore a shareholder change could inadvertently cease the LTC status.
- Unauthorised Ceasing - Although all shareholders are required to approve a revocation, only one shareholder needs to elect with the IRD, therefore there is potential for one shareholder to revoke the LTC election without the knowledge of the other shareholders.
- Forgiveness of Debt - Due to losses, many LTC companies are insolvent and owe money back to the shareholders. Although not intended in the legislation, there are concerns that IRD will treat any write-off of money owed to the shareholders as a taxable transaction, with the shareholders ending up paying income tax on the debt.
- Exit Strategy - As with any structure, to achieve the best outcome consider a strategy prior to exit.

Overall, there are positives and negatives to using an LTC structure however consideration needs to be given on the potential implications of the new LTC system as more is understood and learnt. If you have any questions regarding the options under the LTC regime or how to manage your existing LTC please contact the team at CooperAitken.

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