

LEVEL 4, 56 CAWLEY STREET,
P.O. BOX 11 174, ELLERSLIE, AUCKLAND 1542
TEL 09 580 1291 FAX 09 580 1292. www.streetsmartgroup.co.nz

† Member of New Zealand Institute of Chartered Accountants

Special LAQC Alert: the jury is out

Death of the LAQC as we know it

In May 2010 the Government announced the introduction of flow-through treatment of profits and losses for closely held companies. Government is keen to implement measures that prevent what is sometimes referred to as 'Arbitrage', i.e., the retaining of profits in a company and therefore the utilisation of a company tax rate (28% as of 1 April next year) that is lower than the top personal rate (33% as of the same date).

Their proposals attracted a number of submissions from business and professional groups, including the NZ Institute of Chartered Accountants. Those submissions have had some impact on the original proposals.

Inland Revenue's policy division has now prepared draft legislation to implement the far reaching changes to the Qualifying Company regime. Although the legislation is still in a draft form, it is likely to become final within weeks.



A general overview of the changes and implications

1. As of 1 April 2011, LAQCs will not be allowed to attribute losses to shareholders.
2. The legislation creates a new entity, called a 'Look through Company' (LTC).
3. Companies will be allowed to transition across to become an LTC, or alternatively they can change to another business structure (for example a partnership), without any tax cost.
4. An LTC's profits and losses will be passed on to its owners, according to each shareholder's effective interest in the company. This means that losses and profits will be deducted or taxed at the owner's marginal tax rate.
5. Losses in LTCs will only flow through to owners to the extent that those losses reflect their economic loss. (Getting complicated now)
6. Owners must elect to become an LTC. In other words, we as your accountants will need to complete precise IRD forms to ensure an LTC election is valid.
7. The shareholders of an LTC will be treated as holding the assets of that LTC directly. This raises complex issues where those assets are sold.
8. Remember, this is all a tax fiction only – an LTC retains its identity as a registered company and therefore is still governed by The Companies Act.

We must at this point stress the very general nature of the above overview. The legislation is quite complicated and we know you don't appreciate wordy and complex epistles on tax. It's our job to cut through all of that for you.

Contd...

For those clients with LAQCs, what are the options?

1. Stay as a Qualifying Company (QC). This means you will not be able to allocate any company losses to shareholders. Losses will need to be used by the company, against other income. If your company makes regular losses, and you want to use those losses against personal income (such as profits from another business, or wages from employment), this option may not work best for you.
2. Be taxed as an ordinary company. Once again, you will not be able to allocate company losses to shareholders. Also, you will miss out on certain other benefits that QCs enjoy, such as the ability to distribute capital gains without winding up the company.
3. Be taxed as a Look Through Company (LTC), as summarised above.
4. Restructure to another type of entity, such as a partnership, a limited partnership, or a sole trader. As you can imagine, such a restructure is not necessarily a simple matter.



Your company and the way forward

We have to stress at this very early point that the legislation is still in its draft form. In fact, there are one or two key aspects of the legislation that are yet to be written. By way of example, the Inland Revenue election forms have not yet been designed. As accountants, we need to educate ourselves before we can advise you. And so, over the coming weeks we'll be doing just that.

We'll talk individually to all of our active LAQC clients in the New Year, and we're hopeful that we'll be able to provide you with what we believe is likely to be the best option for you.

The transition across to an LTC or the restructuring for those clients for whom the company vehicle is no longer appropriate, will be completed in the first quarter of 2011.

So, stay tuned and we'll be back to you with an update before Christmas. In the mean time, if you do want to chat about the options and your circumstances do of course call or drop us an email, or attend our SMART Chat on 1 December 2010.

As the old Arab saying goes... *'The dogs may bark, but the caravan moves on.'*

Disclaimer - This publication has been carefully prepared, but it has been written in general terms only. The publication should not be relied upon to provide specific information without also obtaining appropriate professional advice after detailed examination of your particular situation.

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