

Taxing small companies

When the look-through company ("LTC") rules were introduced Inland Revenue proposed a review of the dividend rules as they applied to "closely held" companies.

On 8 September 2015 a paper addressing proposals for change was released.

"Tainted" capital gains

The problem is that realised capital gains derived by a company from a sale of assets to an associated person are taxable on distribution to shareholders.

There is a limited exclusion available to a close company (being a company controlled by 5 or fewer natural persons). A company owned more than 50% by a trust is not then a close company.

The "tainted" capital rule can make planning for family

succession a challenge.

The reason the rule was introduced in the 1980's was to prevent companies ramping up capital reserves for distribution tax-free by companies selling to group companies.

After 30 or so years Inland Revenue thinks that the rule may "inadvertently" catch non-company to company transactions.

We say they have known of the problem for 30 or so years!

It is proposed to allow a close company that disposes of assets for a capital gain to an associated person to not suffer a "tainted" capital gain.

While the proposal is positive it does not go very far as:

1. A sale to an associated company will still result in a "tainted" capital gain; and
2. If the company is majority owned by a trust a sale to an associated person will still result in a "tainted" capital gain.

Resident withholding tax

Currently when a company pays a dividend with 28% imputation credits 5% RWT must be deducted from the cash dividend.

RWT must also be deducted from

October 2015

interest paid to associates of a company.

These two issues are to be reviewed.

In the meantime it is proposed to remove the requirement to deduct RWT from dividends paid by a company to another company.

Shareholder salaries

This is an "old chestnut" which is often misunderstood and not complied with.

Currently a shareholder-employee can, either:

1. have PAYE deducted from their salary; or
2. (subject to meeting certain criteria) elect to not have PAYE deducted from their salary.

That is, the law is "one or the other" but not both.

It is proposed to allow shareholder-employees of close companies to use both options.

If the combination approach is taken, consistency will be required to prevent "flip-flopping" and therefore deferring tax payments.

This is a pragmatic fix!

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Changes to LTC's

Change is not just proposed for close companies.

There are also proposals to toughen up the look-through company ("LTC") rules while softening them a little.

Eligibility criteria

It is proposed that in relation to shareholding trusts that:

- Where a beneficiary has received a distribution of LTC income in the last six years they should be a "counted owner" (currently the time period is three years).
- A company will not be able to be an LTC if a shareholding trust distributes LTC income to a non-LTC company beneficiary.
- Charities and Maori authorities will be prevented from being a shareholder in an LTC; and
- They will also not be able to be beneficiaries of trusts that own shares in LTCs.

The last proposed change if enacted will pretty much prevent any LTC being owned by a family trust because as a general rule family trusts have charities as beneficiaries.

Some what strangely, Inland Revenue observes that the proposed rule will not effect standard charitable donations made by trusts. However, the donations tax credit is not available to trusts and so we cannot agree with the observation. Hopefully the issue will be re-considered and addressed!

It is proposed to allow a company to be an LTC if it has more than one class of share with or without different voting rights as long as all shares are entitled to income and deductions of the LTC.

A restriction is to be introduced on the amount of foreign income an LTC can earn of the greater of \$10,000 or 20%

of its gross income when more than 50% of the LTC's shares are held by non-residents.

Remission income

A significant issue with the LTC rules at present is that remission income arises for the shareholders of an LTC when an amount owed to them by the LTC is subsequently remitted because the LTC cannot repay the loan.

The legislation is (finally) to be fixed to ensure that the remission income rules to ensure that remission income only arises in relation to third party and not to shareholder debt.

Entry tax

Much has been made of the fact that 5% tax can be eliminated if a company with retained earnings and imputation credits becomes an LTC before the retained earnings are paid out to shareholders.

It is proposed to "close the loophole". The entry formula will change to tax taxable reserves at the shareholders' tax rates rather than the company rate of 28%. There will be "winners and losers" under this proposal.

A backdated change will also be made to ensure that an LTC's assets and liabilities are held by the LTC owners on a company becoming an LTC at the tax book values at the time of entry.

Goodbye deduction limitation rule

The deduction limitation rule (often misconstrued as a loss limitation rule) is to go except when there are partnerships of LTCs.

Where a shareholder has deductions carried forward they will be able to utilise those deductions in full against their income (probably) in the 2017/18 income year.

However, the anti-avoidance valuation rule that applies to partnerships whereby partners' transactions with a

partnership must be at market value will be extended shareholders in LTC's.

The aim of the proposals is to make LTC's more attractive to small business and so increase their use. Time will tell if Inland Revenue achieves this!

For us - we doubt it!

Existing QCs

Qualifying companies are to be allowed to continue.

However, it is proposed that qualifying companies will lose their QC status upon change of shareholding of more than 50%. The 50% will be measured in the same way the rules for losses carried forward work.

If enacted, this proposal will create significant compliance risk for QC's and advisers. Think associated person ("tainted") capital gains and imputation credit continuity which is suspended for a QC.

We do not know the mischief Inland Revenue is concerned about but this change will create accountant risk!

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Providing fully researched opinions on the taxation effect of transactions.

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Reviewing tax compliance requirements (FBT, GST, PAYE etc) to identify any deficiencies prior to any visit from tax inspectors.

TAX DISPUTES

Preparation of responses to disputes with Inland Revenue.