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A special report from the
Policy Advice Division of Inland Revenue

New look-through company rules

This special report provides early information on the new rules for look-through companies, which were part of recently enacted legislation in the Taxation (GST and Remedial Matters) Act 2010. This Act amended the Income Tax Act 2007, with minor or consequential changes to the Tax Administration Act 1994 and the KiwiSaver Act 2006.

This special report precedes coverage of the new legislation that will appear in a *Tax Information Bulletin* to be published early next year.

The relevant changes introduced in the Act:

- provide transparent income tax treatment for electing closely held companies, which will be known as look-through companies (LTCs);
- allow existing qualifying companies (QCs) and loss-attributing qualifying companies (LAQCs) to continue to use the current QC rules without the ability to attribute losses, pending a review of the dividend rules for closely held companies; and
- allow existing QCs and LAQCs to transition into the new LTC rules or change to another business vehicle such as a partnership, without a tax cost during the period 1 April 2011 to 31 March 2013.

This report provides guidance on the new look-through company (LTC) rules.

A separate special report contains guidance on the changes to the qualifying company rules, and the various transition options available to existing QC and LAQCs.

Further detailed guidance on the look-through company rules will be available over the coming months on Inland Revenue's website and in a *Tax Information Bulletin*.

Background

As part of Budget 2010 the Government announced reforms to the tax rules for qualifying companies. Feedback on the proposals was sought in the officials' issues paper, *Qualifying companies: implementation of flow-through tax treatment* published the day after the Budget announcement.

Following this consultation it was decided to introduce new rules from 1 April 2011, providing look-through income tax treatment for electing closely held companies.

Under the look-through rules, the company's tax treatment is integrated with the tax treatment of the owners, on the basis that entities are agents for their owners. It ensures that shareholders who use a company's losses also pay tax on any company profit at their marginal tax rate. This removes the tax disincentive faced by the owners of closely held businesses who wish to operate through a company. They can attain the benefits of limited liability afforded by a familiar corporate form, as well as the ability to be taxed at the level of the owner.

An early draft of this legislation was made available for public comment on 15 October 2010, accompanied by an explanatory note. The final legislation, which was enacted on 20 December 2010, is different from the earlier draft, reflecting feedback received during consultation. Some of these changes are fairly substantial while others are more technical in nature. The earlier draft legislation and explanatory note have therefore been superseded by the enacted rules and should not be relied upon.

Key features

Look-through company rules

The new LTC rules are available for income years starting on or after 1 April 2011. The rules apply only to companies which are resident in New Zealand.

The main features of the new rules are:

- An LTC must have five or fewer owners (the ownership interests of relatives are combined).
- All owners must elect for the LTC rules to apply initially. LTC elections are to be made prospectively.
- Once a company becomes an LTC it will remain so unless one of the owners decides to revoke the LTC election, or the company ceases to be eligible.
- Only a natural person, trustee or another LTC may hold shares in an LTC. All the company's shares must be of the same class and provide the same rights and obligations to each shareholder.
- An LTC's income, expenses, tax credits, rebates, gains and losses are passed on to its owners. These items will generally be allocated to owners in proportion to the number of shares they have in the LTC. Owners are also able to deduct expenditure incurred by the LTC before they became a member, subject to the other deductibility tests in the Act.
- Any profit is taxed at the owner's marginal tax rate. The owner can use any losses against their other income, subject to the loss limitation rule.

- The loss limitation rule ensures that the losses claimed reflect the level of an owners' economic loss in the LTC. An anti-avoidance rule also prevents an artificially high basis around the year-end being used to increase any loss flow-through. Owners' excess losses are carried forward to future income years, subject to the application of the loss limitation rule in those years. There are certain rules about the use of these losses if the LTC ceases to be an LTC, or if the owner sells their shares.
- When owners sell their shares they are treated as disposing of their share of the underlying LTC property. Owners may have to pay any tax associated with the deemed disposal of this property. Exiting owners are generally required to account for tax on disposing of their shares in the LTC only if the amount of the disposal proceeds derived from their LTC interest exceeds the total net tax book value of their share of LTC property by more than \$50,000.
- Even if this \$50,000 threshold is exceeded, exiting owners will not have to account for tax on things such as trading stock in certain circumstances. When exiting owners account for tax on their share, incoming owners must take on a cost basis in the LTCs assets and liabilities that is equal to the deemed disposal under the disposal provisions.
- The disposal thresholds do not apply if the company is liquidated, or ceases to use the LTC rules but otherwise continues in business. In these situations, the owner is deemed to have disposed of their shares at market value on the date of exit.
- Look-through treatment applies for income tax purposes only. An LTC retains its corporate obligations and benefits, such as limited liability, under general company law.
- An LTC is still recognised separately from its shareholders for certain other tax purposes, including GST, PAYE and certain administrative or other withholding tax purposes under the Income Tax Act.

Application dates

The application date for both the LTC rules and the qualifying company reforms is the income year starting on or after 1 April 2011.

For companies with an early balance date – for example, a company with a balance date of 31 December, this means that they can start using the LTC rules from their income year from 1 January 2012 to 31 December 2012.

For companies with a late balance date – for example, a company with a balance date of 31 May, this means they can start using the LTC rules from their income year from 1 June 2011 to 31 May 2012.

The LTC election filing rules can be applied from the date of Royal assent. LTC election forms will be available early next year from Inland Revenue. In the interim companies can make an LTC election by writing to Inland Revenue with details of the company and its shareholder, and with signed shareholder elections. The company

director or agent must confirm these elections are complete. Details of the relevant associations between shareholders should also be provided.

Detailed analysis

Legislative structure

New subpart HB of the Income Tax Act 2007 contains the main LTC rules. It introduces the principle that LTCs are transparent for income tax purposes, and contains the LTC election requirements and rules on the tax treatment following an owner's disposal of interests in an LTC.

Section YA 1 introduces several defined terms, including "LTC", "owner's interest", "look-through interest" and "working owner".

Amendments have been made to income and deduction provisions and, in particular, to sections CB 32B and 32C, CX 63, DV 22 and GB 25B, as well consequential changes to the Tax Administration Act 1994 and the KiwiSaver Act 2006.

Definition of "look-through company"

Sections HB 1(1), HB 13(4) and YA 1

A company that elects to use the LTC rules must be a company (that is a body corporate or entity with a legal existence separate from that of its members) that is resident in New Zealand under domestic law and under any relevant double tax agreement. The company residence rules in section YD 2 apply for these purposes; in other words, it is the residence of the company and not its shareholders that is determinative.

A company using the LTC rules must have only one class of shares. All the shares must have the same rights to vote concerning company distributions, the company constitution, capital variation and director appointments, and to receive distributions of profits and net assets. This requirement prevents streaming of income or deductions under the LTC rules.

The shareholders of a company using the LTC rules must be either natural persons or corporate trustees. An ordinary company cannot hold shares in an LTC. An LTC may be the "parent" of another LTC. The sub-LTC's income and expenses will ultimately be attributed to the owners of the parent LTC, and these owners are included in the look-through counted owner test.

An LTC must have five or fewer "look-through counted owners".

To become an LTC, a company must meet all the eligibility criteria and must continue to meet it for the whole of the income year. If an LTC breaches the eligibility criteria its LTC status is lost from the first day of the income year in which the breach occurs. It cannot then use the LTC rules in the year in which the breach occurs or either of the following two income years.

A company that has elected to use the LTC rules is thereafter excluded from the definition of “company” in the Income Tax Act. This means that most of the rules that apply to companies, such as the requirement to keep memorandum accounts and the rules governing payments of dividends, do not apply to LTCs. However, for the following provisions there is no look-through treatment and the company rather than the owners is the relevant entity:

- PAYE
- FBT
- RWT
- NRWT
- ESCT
- RSCT
- Subpart FO (Amalgamation of companies).

The “look-through counted owners” test

Section YA 1

An LTC must have five or fewer “look-through counted owners”. This term applies for this count test only, and although related to shareholdings it is not always transposable with the term “owner” or “shareholder”, such as when an LTC is the parent company of another LTC.

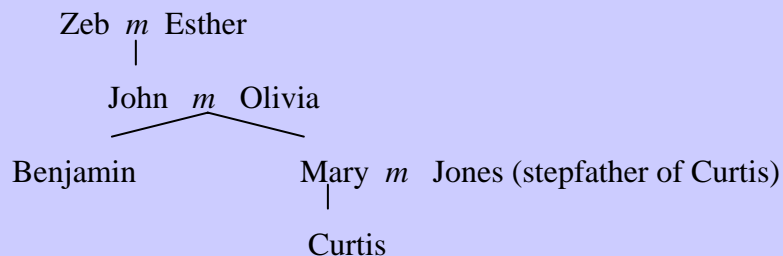
For many LTCs it will be clear that they meet the count test – for example, if the company has only three individual shareholders it clearly has fewer than five shareholders and so fewer than five “look-through counted owners”. However, for companies that have more than five individual shareholders, or that include trustees, the look-through counted owner test needs to be considered.

The look-through counted owner test determines the number of look-through owners the company has for the purposes of the LTC rules by identifying the relationships between individual shareholders. Shareholders related by blood relationships (second degree), marriage, civil union or de facto relationship, or adoption are counted as a single “owner” for the purposes of this test.

The relationship between a step-parent and a step-child is a second-degree relationship.

Death or dissolution of marriage between the shareholders does not break the two-degree test, provided the company was an LTC and the shareholders were counted as “one” before the event.

Example 1: Natural person shareholders



In the example above, if Zebulon, Esther, Benjamin, Mary, Jones and Curtis all held shares in a company they would be counted as a single look-through counted owner because they are related to each other (via Mary) within two degrees.

If only Jones, Esther and Curtis held shares they would be counted as two look-through counted owners because although Jones, as his stepfather, is related to Curtis within two degrees, neither of them are related to Esther within two degrees, as she is Curtis's great grandmother and Jones's grandmother-in-law.

The look-through counted owner test must also be applied if a trustee holds shares in an LTC. Here the test will “look through” to the natural person beneficiaries of the trust (which includes looking through any corporate beneficiaries to its natural person shareholders), if those beneficiaries are allocated income from the LTC as beneficiary income in that income year, or in any of the three preceding income years.

The trustees of a trust are counted as one look-through counted owner for an income year if any income the trust was allocated from the LTC in that income year, and in each of the preceding three income years, was retained by the trust and not paid out as beneficiary income.

Example 2: Trustee shareholder

All the shares in Mountain Design Ltd, an LTC, are held by Walton Trust.

Walton Trust is managed by a corporate trustee. It distributes all of the income from Mountain Design Ltd to the following beneficiaries:

20X1, 20X2 and 20X3	Cora and Emily
20X4	Elizabeth, Emily and Mamie (Emily's sister)
20X5	Rosemary, Erin and Aimee (Cora's daughter)

In 20X1, 20X2 and 20X3 there are two look through counted owners as between them Cora and Emily derived all of the LTC's income as beneficiary income.

In 20X4 there are only three look-through counted owners, Cora, Elizabeth and Emily/Mamie. Because Mamie is Emily's sister (a two degree blood relative) they are counted as one owner.

In 20X5 there are five look-through counted owners, because the test considers who received beneficiary income in the current income year (20X5), and any of the three preceding income years (20X2, 20X3 and 20X4). The look-through counted owners are:

- Cora/Aimee (counted as one)
- Elizabeth
- Mamie/Emily (counted as one)
- Rosemary
- Erin

If a company (including a qualifying company) is the beneficiary of a trust and has received income from the LTC as beneficiary income in that income year, or in any of the three preceding income years, then the company itself is not regarded as a look-through counted owner. Instead the test counts all natural persons who have a voting interest in relation to that company, whether directly or otherwise.

Look-through company elections

Sections HB 1 and HB 13

The LTC regime is elective. A company can only use the LTC rules if it continuously meets all the eligibility criteria, and has filed a valid election with Inland Revenue.

Making an election

All owners must sign an LTC election in order for a company to first become an LTC. A guardian or legal representative must sign for owners aged under 18, or any other owner without legal capacity. The director or other authorised company agent should send the election form to the Inland Revenue, and confirm that all the shareholders have signed it.

The LTC election must be received by Inland Revenue before the start of the income year in which the company wishes to be an LTC. Elections relate to the income year of the company electing to become an LTC; therefore the due date for the election depends upon its balance date.

Newly incorporated or non-active companies must file the LTC election by the date for filing their first income tax return.

If an LTC election is received after the start of the year to which it was intended to apply, or if it is discovered to be invalid because, for example, not all the shareholders signed the election, it may still be accepted as a valid election. The Commissioner's discretion will be exercised only if exceptional circumstances, such as a severe illness, caused the omission or lateness, and if any omission in the election is rectified in that income year.

A company will remain an LTC without any further LTC election. It will cease to be an LTC only if it breaches the eligibility criteria, or the LTC election is revoked.

Revoking an election

Any owner may revoke the LTC election. It does not matter whether they were one of the initial owners who signed the election or not. The revocation notice must be received by Inland Revenue before the start of the income year to which it applies. A copy should be sent to the director of the LTC, to ensure that all owners are aware of the change in status.

If a revocation notice is received after the start of the income year to which it relates, the Commissioner may still accept it, if it was late due to exceptional circumstances.

A revocation may be ignored if the owner issuing the revocation notice disposes of all their interests in the LTC, and the person(s) who acquire these interests advise Inland Revenue before the start of the relevant income year that the previous owner's revocation notice is to be reversed.

To protect the integrity of the new rules, if an owner revokes the LTC election the company cannot use the LTC rules in the year for which the revocation is made, or in either of the following two income years.

Becoming a look-through company

Sections CB 32C and HB 3

Any loss balance of a company from income years prior to becoming an LTC is cancelled when it becomes an LTC.

If a company becomes an LTC after its first year of trading, its reserves are regarded as held by the owners in proportion to their look-through interest. So when a company first becomes an LTC, each owner will be deemed to have an amount of income arising on the first day of the income year the company becomes an LTC. This is necessary because under the LTC rules these reserves may be distributed or drawn down upon without the owners being subject to tax upon distribution; this treatment is not intended to apply to previously accumulated company reserves.

Similar rules apply if a company that is not an LTC amalgamates with an LTC.

The amount of each owner's income is equal to their proportion (based on look-through counted interests) of the amount of the company's reserves that would be taxable if the company was liquidated and assets distributed to shareholders. The formula to determine the amount of these reserves, which applied to the company immediately before it became an LTC, is:

$$\left(a + c - b - \frac{c}{d} \right) - e$$

Where:

- a is the amount that would be taxable dividends of the company on distribution following a deemed winding up.
- b is the assessable income, less allowable deductions, that would be derived by the company on a deemed winding up. This includes items such as depreciation recovered, bad debts and loss on sale of assets.
- c is balances on the company's ICA and FDP account immediately before becoming an LTC, plus any unpaid income tax for earlier years, less any income tax refunds due from these earlier years.
- d is the company tax rate in the income year before the income year in which the company becomes an LTC.
- e is the exit dividends that, if the company had previously been an LTC and is now re-entering the LTC rules, would be attributed to any retained reserves from the previous LTC period that have not since been distributed.

Each owner is subject to tax on their proportion of these reserves, which are regarded as an income amount to them. This income amount is deemed to arise to owners in the income year the company becomes an LTC, and each owner pays income tax on the amount at their personal tax rate.

Slightly different rules apply to existing QCs or LAQCs who choose to transition to the LTC rules in either the first or second income year that starts on or after 1 April 2011. Please refer to the special report on the qualifying company changes for more details.

Ceasing to be a look-through company

Sections CD 43 and CX 63

If a company ceases to be an LTC but continues in existence, it will be taxed as an ordinary company. Any retained revenue profits held by the company would have been previously allocated to owners who would have been subject to tax on this income in the year the income was derived.

To prevent any double taxation of this income, dividends paid by the company in income years after it ceases to be an LTC will be regarded as paid firstly from this retained revenue profit until an amount of dividends equal to the amount of retained profit has been paid. This applies whether the dividends are paid to the same shareholders as held shares while the company was an LTC or to new shareholders.

Dividends regarded as paid from this retained revenue profit are excluded income in the hands of the shareholder recipients.

The available subscribed capital formula is adjusted to reflect capital distributions made while the company is an LTC, so taking into account both equity subscriptions and returns on that equity.

A look-through company is transparent

Sections CB 32B, DV 22, GB 23(2), GB 25B, GB 29, HB 1(4)–(5) and HB 2

With some exceptions, for the purpose of the Income Tax Act, owners are generally treated as carrying on activities and having the status, intention and purpose of the LTC. And the LTC is treated as not carrying on these activities or having such an intention or purpose. The exceptions to look-through include for the purposes of the: PAYE rules, the FBT rules, the RWT and NRWT rules, the ESCT rules, the RSCT rules and subpart FO (which deals with the amalgamation of companies).

Generally though, LTCs are transparent for income tax purposes. Owners are treated as holding property in proportion to their effective look-through interest, and as parties to an arrangement, and doing or being entitled to a thing, through their capacity as owner, unless the context requires otherwise.

An owner's effective look-through interest in an LTC is measured by the percentage of decision-making rights carried by their shares in the company in relation to

dividends or other distributions, the company constitution, variation of the company's capital and director appointments or elections.

Methods for allocation of income and deductions

Income, expenses, tax credits, rebates, gains and losses are passed through to owners. These items are generally allocated in accordance with an owners' effective look-through interest in the company, and will usually be allocated according to their average yearly interests, as if each item occurred uniformly throughout the year.

If the voting interest or market value interest varies during the year, owners may use the weighted average basis to determine their effective look-through interest, as shown in Example 3a.

When the company has a market value circumstance in the year, the owner's effective look-through interest is calculated as the average of their voting interest and the market value interest in the company for the income year.

Example 3a: Income and deduction allocation – average yearly interests

Walnut Ltd is an LTC with a standard balance date.

For the first nine months of the year Charles holds 60% of the shares, and his wife Caroline holds 40%. On 31 December Caroline sells all her shares to Laura.

Caroline and Laura have been shareholders for nine months (275 days) and three months (90 days) respectively.

Walnut Ltd's income statement for the year shows:

	\$
Trading income	500,000
Allowable expenses	<u>(300,000)</u>
	<u>200,000</u>
Gross interest	10,000
RWT (28%)	(2,800)

The income and deductions are regarded as accruing evenly throughout the year, and are allocated to each shareholder based on their yearly average as follows:

Charles's allocation is determined as:

		\$
Trading income	0.6 x 500,000	300,000
Allowable expenses	0.6 x 300,000	<u>(180,000)</u>
		<u>120,000</u>
Gross interest	0.6 x 10,000	6,000
RWT (28%)		(1,680)

Caroline's allocation is determined as:

		\$
Trading income	$(275/365) \times 0.4 \times 500,000$	150,000
Allowable expenses	$(275/365) \times 0.4 \times 300,000$	<u>(90,000)</u>
		<u>60,000</u>
Gross interest	$(275/365) \times 0.4 \times 10,000$	3,000
RWT (28%)		(840)

Laura's allocation is determined as follows:

		\$
Trading income	$(90/365) \times 0.4 \times 500,000$	50,000
Allowable expenses	$(90/365) \times 0.4 \times 300,000$	<u>(30,000)</u>
		<u>20,000</u>
Gross interest	$(90/365) \times 0.4 \times 10,000$	1,000
RWT (28%)		(280)

Alternatively, if the voting interest or market value interest varies during the year owners can use their actual look-through interest in each period during the income year. This is applied to the income, expenses and other flow-through items from each period, and then added together. This requires accurate accrual accounts to be prepared for each period of ownership within the income year.

Example 3b: Income and deduction allocation – accounts method

If, in example 3a, Walnut Ltd had drawn up a full accounts and a profit and loss statement for the period before and after Caroline disposed of her shares it would have shown shown:

	1 Apr to 31 Dec	1 Jan to 31 Mar	Annual
	\$	\$	\$
Trading income	100,000	400,000	500,000
Allowable expenses	<u>(100,000)</u>	<u>(200,000)</u>	(300,000)
	<u>Nil</u>	<u>200,000</u>	200,000
Gross interest	7,500	2,500	10,000

Charles's allocation for the year is the same as in example 3a.

Caroline's allocation for the 1 Apr to 31 Dec period is determined as:

Trading income	0.4 x 100,000	40,000
Allowable expenses	0.4 x 100,000	<u>(40,000)</u>
		<u>Nil</u>
Gross interest	0.4 x 7,500	3,000
RWT (28%)		(840)

Laura's allocation for the 1 Jan to 31 Mar period is determined as:

Trading income	0.4 x 400,000	160,000
Allowable expenses	0.4 x 200,000	<u>(80,000)</u>
		<u>80,000</u>
Gross interest	0.4 x 2,500	1,000
RWT (28%)		(280)

The Commissioner may require the LTC to use this accounts method if its assessable income in a 12-month period is \$3 million or more, and if the Commissioner considers that the accounts method will result in a more equitable and reasonable measure of effective look-through interest in an income year.

Excessive effective look-through interests

The Commissioner may adjust the effective look-through interests of owners and consequently the income and deduction allocation if he considers that the current application provides excessive income allocations to an owner aged under 20.

This is an anti-avoidance provision, and aims to prevent income being unduly diverted to owners under the age of 20. It applies when two or more owners of an LTC are relatives, and one of them is under 20 years. In reallocating income and deductions for an income year, the Commissioner will consider the value of the contributions by way of service or capital rendered by the owner aged under 20, together with any other relevant matters.

Excessive remuneration to relatives

The Commissioner may adjust the allocation of income and deductions from the LTC to its owners if the LTC employs a relative of the owner, and the Commissioner considers that the remuneration paid to the relative for their services is excessive.

This is an anti-avoidance provision, to prevent income being unduly diverted to an owner's relatives. In reallocating income and deductions for an income year, the Commissioner will consider the nature and extent of services rendered by the relative, and any other relevant matters.

This provision does not apply if the relative is aged over 20 at the date of entering into a written contract of employment with the LTC, providing they have real control over the income paid to them under the contract.

Income from personal services

For the purposes of applying the attribution rule for income from personal services, (section GB 27) an LTC is treated as the associated entity, and is not treated as transparent.

Loss limitation

Sections HB 11 and HB 12

New section HB 11 ensures that owners' deductions are restricted if the amount of the deductions exceeds the adjusted tax book value of their investment in the LTC (the "owner's basis"). In that event, the deductions an owner can claim are limited to an amount equal to their owner's basis.

This is an anti-avoidance provision; it will generally only apply if a company's tax losses are not matched by the owner's contributions. The rule aims to ensure that owners can offset tax losses only to the extent these reflect their economic losses. This reflects the fact that owners of a company enjoy limited liability under the corporate veil.

The owner's basis is calculated for each owner using the following formula:

$$\text{investments} - \text{distributions} + \text{income} - \text{deductions} - \text{disallowed amounts}$$

Where:

investments is the sum of the equity, goods or assets introduced or services provided to the LTC, or any amounts paid by the owner on behalf of the LTC. This includes any loans, including shareholder current account credit balances, made by the owner to the LTC and their share of any LTC debt which they, or their associate, have guaranteed (or provided indemnities for).

distributions is anything paid out to the owner by the LTC, including dividends and loans, including shareholder current account debit balances. It does not include any salary or wages received by a working owner.

income is the owner's share of the LTC's income (including exempt and excluded income) and capital gains from the current and any preceding tax years (in which the company was an LTC).

deductions is the owner's share of the LTC's deductions and capital losses in the preceding tax years (in which the company was an LTC).

disallowed amount is the amount of investments made by an owner within 60 days of the last day of the LTC's income year if these are distributed or reduced within 60 days after the last day of the income year. This is to prevent the creation of an artificially high basis around the end of the year. To allow for normal operational cash-flow, if the reduction of investments within 60 days of the balance sheet date is less than \$10,000, it may be ignored.

Example 4: Loss limitation

Oleson Ltd, an LTC starts to operate a plant hire business in 20X1. It has three owners, Eleanor, William and Harriet, with shareholdings of 20%, 30% and 50% respectively.

Oleson Ltd is given a non-repayable business grant by a local entrepreneurial fund of \$50,000. Its owners contribute a further \$100,000, each contributing in proportion to their shareholding. Oleson Ltd also has a \$100,000 interest-only loan from the bank, which Harriet has personally secured by guarantee against her residential property.

Plant	\$250,000
Shareholder capital	\$100,000
Entrepreneur grant	\$50,000
Bank loan	\$100,000

The plant is depreciable at 20% pa – \$50,000.

Repair and maintenance costs are \$20,000 pa.

Interest costs are \$10,000 pa (10% interest rate pa).

The plant produces hire income of \$60,000 pa. Oleson Ltd pays total dividends of \$30,000 each year. For the first five years of trading Oleson Ltd’s accounts will show:

	\$
Income	60,000
Repairs	(20,000)
Interest	(10,000)
Depreciation	<u>(50,000)</u>
Net loss	<u>(20,000)</u>

The owner’s basis (there are no disallowed amounts in this example) determines the amount of their share of the \$80,000 deductions that each owner can claim as follows:

\$	Investment	Distribution	Income	Prior year deductions	Owner’s basis	Current year deductions allowed:	Restricted deductions c/f
20X1							
Eleanor	20,000	6,000	12,000	0	26,000	16,000	0
William	30,000	9,000	18,000	0	39,000	24,000	0
Harriet	150,000	15,000	30,000	0	165,000	40,000	0
20X2							
Eleanor	20,000	12,000	24,000	16,000	16,000	16,000	0
William	30,000	18,000	36,000	24,000	24,000	24,000	0
Harriet	150,000	30,000	60,000	40,000	140,000	40,000	0
20X3							
Eleanor	20,000	18,000	36,000	32,000	6,000	6,000	10,000
William	30,000	27,000	54,000	48,000	9,000	9,000	15,000
Harriet	150,000	45,000	90,000	80,000	115,000	40,000	0
20X4							
Eleanor	20,000	24,000	48,000	38,000	6,000	6,000	20,000
William	30,000	36,000	72,000	57,000	9,000	9,000	30,000
Harriet	150,000	60,000	120,000	120,000	90,000	40,000	0
20X5							
Eleanor	20,000	30,000	60,000	44,000	6,000	6,000	30,000
William	30,000	45,000	90,000	66,000	9,000	9,000	45,000*
Harriet	150,000	75,000	150,000	160,000	65,000	40,000	0

* The special report published on 23/12/10 showed an incorrect amount in this cell. Correction made on 19/01/11.

Any deductions that an owner does not claim in an income year due to the operation of the loss limitation rule are carried forward and may be claimed in future years, subject to the application of the loss limitation rule in those years.

If the company ceases to be an LTC but continues in business as an ordinary company, the owner may use any “restricted deductions” against any future dividends he or she receives from the company.

If the owner ceases to hold shares in the company and so ceases to have an effective look-through interest in the LTC, the “restricted deductions” cannot be used unless the owner later reacquires shares in the same company.

Disposal of look-through interests

Sections FB 1(3), FB 10B, FC 1(2), HB 4 to HB 10

Disposal of shares is disposal of underlying LTC property

The owners of an LTC are treated as holding LTC property directly, in proportion to their effective look-through interest. When owners sell their shares in the LTC they are treated as disposing of their share of the underlying LTC property, and will bear any tax consequences associated with the disposal.

However, sections HB 5 to HB 10 remove the requirement for the owner selling the shares (the “exiting owner”) to account for tax on this disposal of underlying property when the tax adjustment that would otherwise be required is below certain thresholds.

When a look-through interest is transferred as part of a settlement of relationship property, and the rules in subpart FB apply, there is no disposal of shares under the LTC rules. Instead, the transferee is treated as having acquired the look-through interests on the date they were acquired by the transferor, and will take on the transferor’s cost basis. This only applies in relation to the disposal provisions. For the purposes of allocating an LTC’s income or deductions in the year of transfer, the weighted average basis or the accounts method discussed above will apply to the transferor and transferee’s periods of actual ownership in the year.

Deemed disposal of underlying LTC property

If the company ceases to use the LTC rules, but the company otherwise continues, the owner is deemed to have disposed of the underlying property at market value on the date of exit. The company is deemed to have immediately reacquired the property at the same market value.

For the purposes of the land provisions in subpart CB, the associated person rule in section CB 15 applies. This means that the “date” on which the company is regarded as acquiring land is the same date on which the “owners” (via the LTC) acquired the land. The owners are effectively regarded collectively as the transferor, and the company as the transferee.

If an owner ceases to hold interests in the LTC because it permanently ceases to exist as a company – for example, through liquidation or court order, there is a deemed disposal of the shares, at market value.

An owner's interest may also be reduced by cancellation or repurchase of their shares by the LTC. This is a deemed disposal of the shares for their market value, unless it is part of a pro-rata cancellation applied to all owners, and so does not actually alter each owner's effective look-through interest.

In the case of permanent cessation or share repurchase, any actual consideration received by the owner is ignored; the disposal is deemed to occur at market value.

The disposal threshold provisions in sections HB 5 to HB 10 do not apply in these deemed disposal circumstances.

Disposals thresholds

Sections HB 5 to HB 10 remove the requirement for the owner selling the shares (the "exiting owner") to account for tax on this disposal of underlying property when the tax adjustment that would otherwise be required is below certain thresholds.

When these provisions apply, the new owner (the "entering owner") is treated as acquiring their interests in the LTC's underlying property for the same cost that the exiting owner had acquired them.

The thresholds are:

\$50,000 threshold

Exiting owners are required to account for tax on sale of shares only if the amount of the disposal proceeds exceeds the total net tax book value of the owner's share of the LTC property (less any liabilities under generally accepted accounting practice) by more than \$50,000. When shares in the same LTC have been sold within a 12-month period, all sales are taken into account for the purposes of the threshold.

Trading Stock

Exiting owners do not have to perform a revenue account adjustment for trading stock if the LTC's total annual turnover is \$3 million or less.

Depreciable tangible property

Exiting owners do not have to account for depreciation recovery or loss on their share of any depreciable tangible asset if the historical cost of the asset is \$200,000 or less.

Financial arrangements

Exiting owners are not required to perform a base price adjustment for their interest in a financial arrangement if:

- the LTC is not in the business of deriving income from financial arrangements; and
- the financial arrangement has been entered into as a necessary and incidental purpose of the LTC's business.

Exiting owners do not have to account for tax on financial arrangements and excepted financial arrangements described in section EW 5(10).

Short-term sale and purchase agreements

When exiting owners dispose of some or all of their look-through interests in a short term sale and purchase agreement, the consideration received is excluded income.

Livestock

If the LTC property consists of livestock that includes female breeding livestock that is valued using the national standard cost scheme (section EC 22) or the cost price method (section EC 25), the entering owner may furnish a return of income choosing to apply section EC 26B. The entering owner is treated as if they had originally purchased and held the livestock, not the exiting owner. This is designed to reduce compliance costs for the LTC.

Working owners

Sections DC 3B, HB 11(6), RD 5(3) and YA 1, and section 14(1) of the KiwiSaver Act 2006

A working owner is an owner who is employed by the LTC under a written contract of employment and who personally and actively performs the duties of their employment for the LTC under that contract. This does not apply if the LTC is wholly or mainly engaged in investing money or in holding or dealing in shares, securities, investments, estates or interests in land.

An LTC's payments to a working owner are included in that owner's salary or wages, and the PAYE rules will apply. When computing their owner's basis, these wages or salaries are excluded from the distributions element of the formula.

An expense deduction is available to all owners of an LTC for wage and salary payments made to working owners.

The rules for automatic enrolment of employees into KiwiSaver do not apply to an owner in receipt of salary or wages only because they are a working owner in an LTC.

Interests in livestock

Section EC 12(4)

For the purposes of making a valuation election for specified livestock, a person's interests in an LTC that owns livestock is treated separately from any other interest that person may have in livestock. Separate elections are needed for each set of livestock, and different valuation methods may be applied to each.

Excepted financial arrangements

Section EW 5(11B)

A look-through interest for an LTC is an excepted financial arrangement.

Associated persons

Section YB 13

The LTC and an owner who is an employee or a director of the LTC are associated.

The LTC and an owner who has effective look-through interests of 25% or more are associated.

The look-through interests of owners associated under sections YB 2 to YB 11 and YB 14 are aggregated. A slightly modified aggregation rule applies for the purposes of land provisions.

Tax administration

Sections 42B, 89C(ka), 89D(1), 89DA, 138B and 141B(8) of the Tax Administration Act 1994

An LTC must file a return of income, ignoring the look-through requirements. The return must specify the amount of income and deductions allocated to each owner.

Only the LTC may propose adjustments to the tax position taken in its return, which the Commissioner may reject by written notice. The LTC may also reject any adjustments proposed by the Commissioner. An owner is entitled to challenge any assessment in relation to their interests in the look-through company by commencing proceedings in a hearing authority only after the disputes process in Part 4A is completed.

The Commissioner may issue an assessment to an owner on their tax position in relation to their look-through interests without issuing a notice of proposed adjustment if the LTC and the Commissioner have completed the disputes process for the return of income and that tax position.

For the purposes of applying shortfall penalties, and for determining a tax shortfall amount, the amounts returned on the tax return of the LTC are treated as if they were the amounts returned by each owner.