

THE BUDGET / YOUR LAQC/ THE FUTURE

What do the proposed changes mean for you and your LAQC? (Loss Attributing Qualifying Companies)

The Government is proposing to replace the existing qualifying company rules with new rules making qualifying companies and LAQCs flow-through entities for income tax purposes. Qualifying companies are currently subject to company tax treatment, whereby income is taxable and losses deductible by the company at the company tax rate. In addition, LAQCs are partially transparent entities in which income is retained at the company level but losses can flow through to individual shareholders. Attributed losses are treated as if they were incurred by a shareholder in deriving their income, and so these can be offset against the shareholder's other income or be carried forward to future years.

With the proposed flow-through treatment for income tax purposes, a qualifying company's income and losses will both be passed on to shareholders. That is, (the profit) will not be retained at the company level. Instead, income will be taxed and losses deducted at a shareholder's marginal tax rate.

What does all this mean in layman's terms and how might it effect you?

1. With depreciation on buildings no longer being able to be claimed as a tax write off your tax refund will not be as big. For some of you this may mean a cash loss of between \$20 - \$40 per week and this of course will depend on how many properties you hold.
2. When your investment property(s) turn a profit, this profit will now be required to be allocated direct to you in the same proportion as your shareholding interest in the company. So where previously there was the option that the profit could be retained in the company and taxed at the company tax rate this will now be taxed at your individual marginal tax rate when allocated.

Is there any disadvantage here?

For those of you who will be paying tax at the rate of 33% (that is, on incomes over \$70,000) we don't see any real disadvantage because previously the company would have paid the tax at the rate of 30% anyway, and the difference of 3% would not have been significant.

3. The use of losses by shareholders will be subject to a loss limitation rule. You still get to claim the realised tax losses each year but this loss will be limited to the shareholder/s investment in the LAQC. If the allocated loss exceeds the value of the shareholder/s investment, for tax purposes the excess losses may be carried forward by the shareholder until the shareholders investment in the company increases. What is meant by **shareholders investment** is otherwise referred to as your **shareholders current account** balance and this balance reflects generally the amount of cash you have advanced to the company over time.

The proposed legislation changes also refer to what "shareholders have at risk". We understand that this will include what the shareholder has had to guarantee the bank in terms of the company's level of borrowings. There is, however, more to come on this and we suspect a formulae to determine the calculation will be released at some time.

The rationale behind restricting a shareholder's tax losses in any given year is to ensure that the tax losses claimed reflect the actual level of that shareholder's economic loss, that is the cash that is at risk that you have advanced the company. When there is a profit you will be paying tax on this accordingly, so nothing of significance has really changed here. You still get the opportunity to get a tax refund back at the end of the financial year by claiming the attributed losses, providing, you still have a positive shareholder's current account balance **(your shareholders interest)**.

Hidden Traps

So, two traps for the unwary property investor will be:

- A. The limitation of the losses and this, we believe, will be a case by case basis.
- B. Depreciation recovery on the sale of QC shares.

LAQCs have generally been used to hold portfolios of loss-making rental properties to take advantage of the tax rate mismatch. Then once a portfolio is profitable, LAQC status is often revoked and shares transferred to a Trust, thus capping the tax liability on future rental profits at the Trustee tax rate of 33% - not the top personal tax rate.

The proposed new rules mean a sale of QC shares at market value to a Trust will generally result in depreciation recovery income, if market value is more than the depreciated value of the building component. However, as a QC will still be a company for non-tax purposes, it will incur no conveyance costs because the investment property will legally be owned by the same entity before and after the sale of shares. QCs may therefore still have their place in an investor's investment strategy.

- 4. Depreciation Recovered: Under the new regime if a shareholder disposes of their shares or transfers their shares (say between spouses) this will be treated as disposing of their share of the underlying property, which could result in depreciation recovered. This was not an issue under the old regime.
- 5. All LAQC's will be renamed QC's (Qualifying Companies). QC's will then be defined and treated as a Partnership for tax purposes rather than a company, and in the future will file an IR7 Partnership Tax Return.
- 6. So what should you be doing?
 - A. Should you be looking at doing anything different at this point in terms of your current ownership structure?

We don't believe so, and note that these are just proposed changes which still need to be enacted into law.

- B. What if you have a special tax code?

With the reduction in individual tax rates and where the depreciation on buildings will no longer be a claimable expense, in certain circumstances you may not meet the eligibility requirements for a special tax code. However, in calculating your special tax code at this time consideration will also need to be given to your investment in the company as shareholders.

- C. Should you look at changing your shareholding now?

This, we believe, will be a special interest area of the Inland Revenue Department and if your sole purpose for changing the shareholding is to gain a tax advantage then the answer is NO. You will need to have some sound commercial reasons why you have changed your shareholding, backed up by some good supporting documentation in the event that this was ever queried by the Inland Revenue Department.

- D. What about if you are contemplating the purchase of an investment property now?

We believe this is a case by case basis and you should make contact with one of our Senior staff members to run over your own position.

- E. If your LAQC is a trading company, by this we mean it undertakes a business activity other than owning an investment property, how do the proposed changes impact on your company?

We believe this is a case by case basis and you should make contact with one of our Senior staff members to run over your own position.

So it's pretty much business as usual and not as bad as many had predicted.

We will be updating our website when further information comes to hand and when the legislation has been drafted



On The Investment Property Front

Some thoughts:

1. In many cases buying a rental property has largely been made viable by the big tax loss and tax refund that stems from depreciation. This now may mean less buyers in future and less demand, therefore, this is likely to impact on future capital gain.
2. Most economists and business commentators believe property values will reduce and a factor of 4% seems to be the general consensus.
3. With low rental yields and little prospect of future capital gains we believe you will need to do a lot more homework to make sure that an investment in a rental property is right for you.
4. You might now be better to use what would have otherwise been the “rental top up” and make additional monthly contributions to your KiwiSaver.
5. The focus for you as a property investor now is to look to get a gross rental that will cover your interest costs, rates, insurance and maintenance on the property.

That's not easy but with limited prospects of capital growth and a much reduced or limited tax refund, is your property investment going to be a good future investment? Only time will tell.

Please note the above comments are the writers thoughts only, and do not constitute financial advice.

Warren Perriam