

Client Newsletter

June/July 2008

Qualifying companies and distributions

Qualifying companies are ordinary companies with a special tax status. Qualifying companies (QC) and for that matter Loss Attributing Qualifying Companies (LAQC) are able to make dividend distributions to their shareholders tax-free if all the imputation credits are used up, whereas an ordinary company is not able to distribute such dividends tax-free.

Capital gains

This may arise if the company's business is sold at a profit or the company's assets are sold at a higher value than its cost.

In an ordinary company, the capital gain is taxed as deemed dividends in the hands of the shareholders if it is distributed without winding up the company. With a qualifying company status there is no tax issue since the shareholders are able to access the capital gain immediately.

If there are any imputation credits in its Imputation Credit Account, then these have to be used up first, thereby making it a normal, taxable dividend as in an ordinary company. However, once the imputation credits are used up, the balance of the distribution is tax free to the shareholders.

There is one problem though that the shareholders have to be aware of – by having to attach the available imputation credits in such a distribution and thus making it a taxable distribution, shareholders already on a high marginal tax bracket (of 39%) may end up paying an extra 6% (or 9% from the 2009 tax year) on the taxable portion of the distribution as it

will be imputed at 33% (or 30% from the 2009 tax year).

Liquidation

A problem may arise where a QC is put into voluntary liquidation and remission income arises from creditors who have released the company from its obligation to pay them. Since the company would have claimed expenses (and thereby tax) in an earlier year, non-repayment of creditors will give rise to taxable income.

Remission income may not necessarily arise from outside suppliers only; it could easily be from a shareholder loan that is being forgiven by the shareholders. In such a case, it may constitute a financial arrangement and the base price adjustment may make it taxable income to the company. Since the shareholders of a QC are personally liable for any income tax payable by the company, they would have not only lost out on their original loan to the company that remains unpaid, but may end up paying tax on the income that arises on the company's debts!

There are ways to avoid such a situation before it is too late. One way is to capitalise the shareholder loan on a regular basis (not just before the company is put into liquidation as it may be deemed tax avoidance).

Another way out is to revoke the qualifying company status of the company before placing it into liquidation. In an ordinary company, debt remission does become assessable income, but the tax liability of the company is not passed down to the shareholders.

The Inland Revenue has introduced a new process for obtaining IRD numbers in an effort to prevent identity theft and fraudulent use of IRD numbers.

No longer can a tax agent apply for an IRD number for an individual. The applicant is now required to produce two original identity documents, one of which must have a photograph of the applicant, to any AA (Automobile Association Driver Licensing

Agent), PostShop or selected New Zealand Post outlets along with the photocopies. These could be passports, driver licences, or birth certificates.

These selected agencies will then confirm the applicant's identity and send photocopies to the Inland Revenue Department, who will then send the IRD numbers directly to applicants within 8-10 working days.

Redundancy rebates

Previously, those taxpayers who were in a lower tax bracket received redundancy payments found themselves in the higher tax bracket in that one year in which they received the redundancy payout. The taxation rules in such a case did not provide a fairer tax rate to these taxpayers who were pushed into the higher tax bracket for only that year.

Changes to legislation now ensure that taxpayers can get some relief by claiming rebates on redundancy

receipts from 1 April 2008 for redundancy payments made after 1 December 2006. The rebate is pitched at a flat rate of 6% of the redundancy payout but capped to a maximum of \$3,600 (or redundancy payment of \$60,000) on a per redundancy basis.

Although redundancy receipts are taxable, the rebates will give some tax relief to lower and middle-income earners who would otherwise be overtaxed in any one given year.

Accounting fee accruals

A recent Taxation Review Authority (TRA) case on the tax deductibility of accrued accounting fees will most likely see an end to the practice of accruing such fees in year-end financial accounts.

Most businesses accrue accounting fees for preparation of their financial accounts in the same income year. For example, accounting fees for the 2007 financial accounts are accrued in the 2007 income year when in actual fact the 2007 financial accounts are not prepared until after the end of the 2007 financial year, ie 2008 year or in some cases even later.

Generally, expenses that are incurred in an income year, but not paid by the business before the end of that income year, are accrued as there is an obligation

to pay at balance date. For example, an unpaid invoice received from a supplier for goods or services performed during that income year (and provided the invoice is dated 31 March or earlier date of that income year, assuming it is a March balance date) the expense is definitely committed and therefore accrued at balance date.

In case of accounting services, the work would not have even started, let alone performed by balance date to be able to accrue the accounting fees for that year. The TRA decision does make sense in this case. However, as clear as it may appear, one can still argue whether a definite commitment exists in a situation where an engagement letter to perform the accounting services is accepted.

Important: This is not advice. Clients should not act solely on the basis of the material contained in the *Client Newsletter*. Items herein are general comments only and do not constitute or convey advice per se. Changes in legislation may occur quickly. We therefore recommend that our formal advice be sought before acting in any of the areas. The *Client Newsletter* is issued as a helpful guide to clients and for their private information. Therefore it should be regarded as confidential and should not be made available to any person without our prior approval. 173/08.