NEW ZEALAND'S LOOK-THROUGH COMPANY REGIME AND COMPLIANCE COSTS: THROUGH THE EYES OF THE PRACTITIONER

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ABSTRACT

New Zealand's tax regime is distinct in offering a specific entity targeted towards closely held companies, the look-through company ('LTC'). One of the stated policy intents of the LTC regime is reducing compliance costs. This research sought the views of tax practitioners as to uses for the LTC regime, advantages of the LTC regime, disadvantages of the LTC regime and the complexity of the LTC regime. Notably, practitioners viewed the LTC regime as being complex and giving rise to increased compliance costs for those that use the regime. Part of this complexity arose from the now repealed loss/deduction limitation rule, however, other drivers of complexity still exist. To this end, further overhauls are recommended.

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I INTRODUCTION

One of the earliest authors to associate a cost with tax compliance was Adam Smith, who propounded four canons of taxation: equity, certainty, convenience and economy.[1] Amongst these four canons, certainty and convenience of payment are wholly concerned with tax compliance costs, whilst economy in collection is concerned with both the collection and efficiency costs of tax.[2] Compliance costs are different to administrative costs, and are incurred by taxpayers in efforts to comply with tax legislation.[3] Conversely, administrative costs are those incurred by revenue authorities in collecting tax.[4]

Compliance costs arise for a number of different reasons.[5] Perhaps the most important cause of tax compliance costs is the complexity of legislation.[6] Other drivers of tax compliance costs include the administration of the revenue authority itself, tax accounting rules and regulations, and international tax issues.[7] Additional drivers of tax compliance costs include the nature of the taxes themselves, the cost of learning about new taxes or changes, and the processes and procedures of remitting the tax.[8] Further, it is widely acknowledged that smaller businesses have a greater burden of tax compliance costs. This is due to the regressive nature of

[1] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Dent, 1910).

[2] Binh Tran-Nam, 'Measuring Tax Complexity Costs' in Chris Evans, Rick Krever and Peter Mellor (eds), *Tax Simplification* (Kluwer Law, 2015).

[3] Cedric Sandford and John Hasseldine, *The Compliance Costs of Business Taxes in New Zealand* (Victoria University Press, 1992).

[4] Cedric Sandford, Michael Godwin and Peter Hardwick, *Administrative and Compliance Costs of Taxation* (Fiscal Publications, 1989).

[5] Betty Jackson and Valerie Milliron, 'Tax Compliance Research: Findings, Problems, and Prospects' (1986) 5(1) *Journal of Accounting Literature* 125; Maryann Richardson and Adrian Sawyer, 'A Taxonomy of the Tax Compliance Literature: Further Findings, Problems and Prospects' (2001) 16(2) *Australian Tax Forum* 137; Lin Mei Tan and Adrian Sawyer, 'A Synopsis of Taxpayer Compliance Studies: Overseas Vis-a-Vis New Zealand' (2003) 9(4) *New Zealand Journal of Taxation Law and Policy* 431.

[6] Ranjana Gupta, 'Simplify Tax Maze to Grow Small Business: New Zealand Study' (2011) 26(2) *Australian Tax Forum* 173.

[7] Sebastian Eichfelder and Francois Vaillancourt, 'Tax compliance costs: A Review of Cost Burdens and Cost Structures' (2014) 210(3) *Review of Public Economics* 111.

[8] Philip Lignier, Chris Evans and Binh Tran-Nam, 'Tangled Up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector' (2014) 29(2) *Australian Tax Forum* 217.

compliance costs, that is, smaller businesses experience a larger cost burden in comparison to larger businesses.[9] In fact, large businesses often benefit from complying with tax legislation.[10]

Globally, efforts have been made to reduce compliance costs for smaller businesses. In New Zealand, a specific regime targeted towards closely held companies has been adopted as one method to achieve this goal, with the loss-attributing qualifying company ('LAQC') regime being introduced in 1992. New Zealand's closely held company regimes have proved to be popular, with there being an estimated 130,000 active LAQCs when the regime was repealed.[11] However, despite the regime having widespread use, the repeal of the regime was subject to limited public scrutiny and consultation.[12] In fact, the repeal of the LAQC regime was announced during the National Government's budget of 2010. Shortly after, the look-through company ('LTC') regime was implemented in a Supplementary Order Paper during the third reading of a remedial tax bill.[13] Traditionally, changes to tax legislation go through a process known as the Generic Tax Policy Process ('GTPP'), which necessitates public scrutiny and consultation via submissions and the Select Committee process.[14]

This hurried implementation of the LTC regime is understood to be the main cause of the numerous tweaks and amendments made since its enactment. These have ranged from being remedial in nature, to major changes such as the removal of the owner's basis and the loss/deduction limitation rule, which will be discussed further on. These major changes were enacted in 2017, and unlike the original regime, were subject to the GTPP. The use of the GTPP

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9 See, eg, Sandford and Hasseldine (n 4); Colmar Brunton, *Measuring the Tax Compliance Costs of Small and Medium-Sized Businesses - A Benchmark Survey* (Final Report, 2005).

10 Binh Tran-Nam et al, 'Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia' (2000) 53(2) *National Tax Journal* 229. See, eg, Philip Lignier, 'A Silver Lining in the Tax Compliance Cost Cloud? A Study of the Managerial Benefits of Tax Compliance in Small Business' in Margaret McKerchar and Michael Walpole (eds), *Further Global Challenges in Tax Administration* (Fiscal Publications, 2006).

11 New Zealand, *Parliamentary Debates*, House of Representatives, 9 December 2010, 16085.

12 Peter Vial, 'The Generic Tax Policy Process: A "Jewel in Our Policy Formation Crown"?' (2012) 25(2) *New Zealand Universities Law Review* 318.

13 See New Zealand Parliament, 'How a Bill Becomes Law', *How Parliament Works* (Web Page, 12 January 2016) <www.parliament.nz/en/visit-and-learn/how-parliament-works/how-laws-are-made/how-a-bill-becomes-law/>.

14 Adrian Sawyer, 'Broadening the Scope of Consultation and Strategic Focus in Tax Policy Formulation: Some Recent Developments' (1996) 2(1) *New Zealand Journal of Taxation Law and Policy* 17.

resulted in many submissions from tax practitioners and other impacted parties many of whom were not consulted in the first instance.

Whilst one of the original aims of the LAQC regime was to reduce compliance costs, two empirical studies have found that the opposite was true.[15] That is, the use of the LAQC regime resulted in higher compliance costs compared to the other business structures such as ordinary companies, trusts, sole traders and partnerships. Non-empirical studies have also pointed to increased compliance costs for those using the LAQC regime. This is due to more complex and onerous legislative requirements[16] and the tax flow-through treatment offered by the structure.[17] In addition to compliance costs, literature also suggests that the LAQC regime undermined tax neutrality due to the use of LAQCs in tax avoidance arrangements,[18] and because of various inconsistencies in the taxation of LAQCs compared to other tax structures.[19]

In regard to the LTC regime, one study has concluded that the LTC regime and its associated legislation is complex and obtuse.[20] Specifically, the only way that the New Zealand Institute of Chartered Accountants ('NZICA')[21] were able to gain confidence in the original legislation was through policy discussions with officials, which is contradictory to New Zealand's self-assessment system. The LTC regime has also been reviewed from the perspective of various stakeholders, with the authors concluding that the LTC regime has been successful in

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15 Katherine Ritchie, *New Zealand Small Business Tax Compliance Costs - Some Empirical Evidence* (Inland Revenue, 2002); Gupta (n 6).

16 Kevin Holmes, 'The Taxation of Closely-Held Companies: Concepts, Legislation and Problems in New Zealand' (1992) 9(3) *Australian Tax Forum* 323.

17 Brett Freudenberg, 'Is the New Zealand Qualifying Company Regime Achieving its Original Objectives?' (2005) 11(2) *New Zealand Journal of Taxation Law and Policy* 185; Brett Freudenberg, 'The Troubled Teen Years: Is the Repeal of New Zealand's LAQC Regime Required?' (2008) 14(1) *New Zealand Journal of Taxation Law and Policy* 67; Brett Freudenberg, Fact or Fiction? A Sustainable Tax Transparent Form for Closely Held Businesses in Australia (2009) 24(3) *Australian Tax Forum* 375; Brett Freudenberg, *Tax Flow-through Companies* (CCH, 2011).

18 Brett Freudenberg, 'Are Qualifying Companies Quality? The Lessons to be Learnt from New Zealand's Hybrid Entities for Australia' (Conference Paper, Australasian Tax Teachers' Association Conference, 2004); Justice Susan Glazebrook, 'Statutory Interpretation, Tax Avoidance and the Supreme Court: Reconciling the Specific and the General' (2014) 20(1) *New Zealand Journal of Taxation Law and Policy* 9.

19 Freudenberg, 'Is the New Zealand Qualifying Company Regime Achieving its Original Objectives?' (n 18).

20 Aylton Jamieson, 'Loss Limitation Rules - The Sow's Ear' (2011) 90(8) *Chartered Accountants Journal* 46.

21 The New Zealand Institute of Chartered Accountants ('NZICA') merged with the Institute of Chartered Accountants Australia ('ICAA') in 2013 to become Chartered Accountants Australia New Zealand (CAANZ).

eliminating the neutrality concerns associated with the LAQC regime.[22] Furthermore, it has been found that in general, tax flow-through entities, such as the LTC regime, lead to a greater compliance burden for small businesses.[23] Thus, simplification of rules will still lead to a greater overall compliance burden in comparison with other business structures, such as traditional companies.[24]

Despite major changes to the LTC regime in 2017, there are still doubts as to whether the LTC regime is meeting a key objective of closely held company regimes. That is, the reduction of compliance costs for those that utilise the structure. This is especially relevant given the recent review of the Government Tax Working Group, whose scope extended to encompass closely held company taxation. Accordingly, this paper seeks to evaluate the LTC regime through interviews with tax practitioners, with a particular emphasis on compliance costs. Documentary analysis is also used to ascertain Parliament's purpose in enacting the LTC regime, and this is compared with responses from tax practitioners.

Section 2 of this paper briefly outlines the background to New Zealand's LTC regime. For the purposes of this paper tax practitioners are referred to as 'Tax Practitioner 1' through to 'Tax Practitioner 12'. Details of the research method are outlined in section 3. The research results are outlined in section 4. Discussion and analysis are contained in section 5, followed by concluding observations and limitations in section 6.

II BACKGROUND

A *Loss Attributing Qualifying Companies*

The origins of the LTC regime can be traced back to its predecessor, the LAQC regime, which itself is a subset of the qualifying company ('QC') regime. The QC regime was introduced at the recommendation of The Consultative Committee on the Reform of the Taxation of Income from Capital,[25] who were tasked with reviewing New Zealand's income tax system in the 1980s

[22] Divya Sharma et al, 'Look-Through Companies: Stakeholder Perspectives' (2019) 25(4) *New Zealand Journal of Taxation Law and Policy* 365.

[23] Brett Freudenberg et al, 'Comparative Analysis of Tax Advisers' Perception of Small Business Tax Law Complexity: United States, Australia and New Zealand' (2012) 27(4) *Australian Tax Forum* 677.

[24] Office of Tax Simplification, *Lookthrough Taxation* (2016).

[25] Consultative Committee on the Reform of the Taxation of Income from Capital, *The Taxation of Distributions from Companies* (Government Printer, 1990) ('*Valabh Committee*').

and 1990s. One specific aim of the review was to simplify taxation for closely held companies. The QC regime was chosen over other models for the taxation of dividends (a dividend exemption system and a full integration system), as it was concluded that this regime reduced the role taxation played in the choice of business entity, achieved greater integration between company and individual taxation, whilst also minimising complexity,

The New Zealand Income Tax Amendment Act (No.2) 1992, brought this legislation into force. This new regime was open to companies with five or fewer shareholders, with shareholders being related by blood or marriage counting as one shareholder.[26] QCs were taxed on all dividends they received. Conversely, shareholders received either fully imputed dividends or exempt dividends. This means that when the company paid no tax on a profit (e.g. capital profits), those profits flowed through to the shareholder tax-free. Non-cash dividends were exempt.[27] Companies electing to become a QC were subject to qualifying company election tax ('QCET') on entry, which was a final tax on that part of the company's shareholder's funds that were not 'sheltered' by imputation credits. This was changed in 2007 so that payments were credited to the imputation credit account, effectively changing QCET into a withholding tax.[28]

A subset of the QC regime, the LAQC regime, was initially rejected by the Valabh Committee due to fears that different classes of shares would make attributions complicated and impractical.[29] However, a raft of submissions from interest groups forced policymakers to reconsider, and the LAQC regime was permitted provided that there was only one class of shares available.[30] This new structure meant shareholders could elect to access the company's losses if the class of shares requirement was met, and if losses were distributed in proportion to shareholding. The Consultative Committee on the Reform of the Taxation of Income from Capital stated that this change was because the pass through of losses would help achieve one of its objectives: closer integration between taxation of the company and its shareholders.[31]

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[26] Inland Revenue Department, *Tax Information Bulletin Vol 3, No 2* (1991).

[27] *Income Tax Amendment Act (No 2) 1992* (NZ).

[28] Inland Revenue Department, *Remedial amendments: Qualifying Company Election Tax* (2008).

[29] Valabh Committee (n 25).

[30] Bill Hale and Darren Johnson, 'Look-Through Companies: A Diamond in the Rough' (Conference Paper, NZICA Tax Conference, 2011).

[31] Valabh Committee (n 25).

Whilst there was a provision in the legislation aimed at limiting the amount of tax losses shareholders could access, this was largely considered ineffective.[32]

Both the QC and LAQC regimes were subject to few legislative amendments during their existence;[33] however, the LAQC regime was a common component in many tax avoidance arrangements.[34] Examples include *Case Z20*,[35] where the Taxation Review Authority ('TRA') ruled that a taxpayer who bought a home in a LAQC and claimed normal renting expenses, thus resulting in a personal tax loss, was a tax avoidance arrangement.[36] A further example can be found in *Ben Nevis Forestry Ventures Limited and Ors v the Commissioner of Inland Revenue*,[37] where taxpayers utilised the LAQC regime to invest in a forestry scheme. This forestry scheme was deemed by the Supreme Court to be a tax avoidance arrangement, in part due to the excessive losses deducted by shareholders.

These excessive tax deductions resulting from an ineffective loss limitation rule, as well as the differences in tax rates leading to arbitrage opportunities, was the main rationale cited for the repeal of the QC and LAQC regimes.[38] Remission income inconsistency, such as when taxpayers could be allocated losses but not income, was also cited as further rationale. The final rationale cited for the repeal of these regimes was the interaction with the limited partnership ('LP') regime. It has been contended that LAQC regime could have been used to structure around loss limitation rules in the LP regime, as LAQCs could be general partners in a LP.[39] An interesting point is that while the Victoria University of Wellington Tax Working Group identified issues with rental property taxation, the repeal of the LAQC regime was not considered as an option for fixing these issues. Instead, the TWG recommended a risk-free return method ('RFRM') of taxing rental property, which was not adopted by the

[32] Casey Plunket and Nick Wells, *Limited partnerships* (2008).

[33] Hale and Johnson (n 30).

[34] Inland Revenue Department, *Revenue Alert RA 07/01* (2008).

[35] *Case Z20* [2009] 24 NZTC 14,271.

[36] Aaron Quintal and Kirsty MacLaren 'LAQC Structure Ruled Tax Avoidance' (2010) 89(1) *Chartered Accountants Journal* 39.

[37] *Ben Nevis Forestry Ventures Limited and Ors v the Commissioner of Inland Revenue* [2008] 24 NZTC 23,188.

[38] Inland Revenue Department, *Qualifying Companies: Implementation of Flow-Through Tax Treatment* (2010).

[39] Inland Revenue Department, *General and Limited Partnerships – Proposed Tax Changes* (2006).

Government.[40] The most recent Government Tax Working Group will be discussed further in section 5.

B *The Look-Through Company Regime*

1 *Introduction*

The LTC regime, contained in subpart HB of the Income Tax Act 2007, was introduced into Parliament via Supplementary Order Paper 187. It was subsequently enacted on 20 December 2010, as part of the Taxation (GST and Remedial Matters) Act 2010. Submissions from interest groups were not requested, due to the regime being controversially introduced by a Supplementary Order Paper.[41] This meant that key tax policy processes (such as the Generic Tax Policy Process which necessitates public scrutiny) were omitted.[42] However, submissions from interest groups were requested for the later amendments, and the majority of submissions pointed to both the truncated policy development process and legislative complexity of the regime.[43] Table 1 outlines a timeline of the LAQC/QC tax reform process.

TABLE 1 – TIMELINE OF LAQC/QC REFORMS

DATE	**REFORM**
January 2010	TWG Report highlights issue with negative fiscal return from property sector.
7 April 2010	Regulatory Impact Statement on policy options for a tax reform package prepared by Treasury and Inland Revenue.
12 April 2010	Cabinet agrees to replace QC / LAQC rules with flow-through treatment.
20 May 2010	Budget 2010: proposed changes (all QCs to become flow-through vehicles) announced; Budget Regulatory Impact Statement ('RIS') makes scant reference to proposals; brief fact sheet on LAQC / QC changes released.

[40] Victoria University of Wellington, Tax Working Group, *A Tax System for New Zealand's Future* (Final Report, 2010).

[41] For more information on the legislative process in New Zealand: see, Vial (n 12); Adrian Sawyer, 'Reviewing Tax Policy Development in New Zealand: Lessons from a Delicate Balancing of "Law and Politics"' (2013) 28(2) *Australian Tax Forum* 401.

[42] Vial (n 12); Sawyer (n 41).

[43] See, eg, KPMG, Submission to the Finance and Expenditure Committee, *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill 2012* (NZ) (24 February 2012); New Zealand Law Society, Submission to the Finance and Expenditure Committee, *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill 2012* (NZ) (8 February 2012).

24 May 2010	Release of Officials' Issues Paper "Qualifying companies: implementation of flow-through tax treatment".
5 August 2010	Taxation (GST and Remedial Matters Bill) introduced.
19 August 2010	First reading of Bill.
11 October 2010	Minister announces reform and confirms draft legislation to be released later that week and that Government will review dividend rules.
12 October 2010	Minister releases QC reforms Q and A.
15 October 2010	Draft legislation with new approach (the LTC; repeal of loss attribution for LAQCs and QCs grandfathered) circulated to narrow group but not to public.
29 October 2010	Revised tax policy work programme released, including for the first time, reference to reforms of the QC rules.
15 November 2010	Finance & Expenditure Committee reports back on Taxation (GST and Remedial Matters) Bill.
24 November 2010	Second reading of Bill.
November 2010	Circulation of revised draft of legislation for QCs transitioning to NZICA and parties who had commented on transitional issues.
7 December 2010	70-page Supplementary Order Paper released (and introduced 9 December 2010) between second and third readings of Taxation (GST and Remedial Matters) Bill.
9-10 December 2010	Parliamentary debate: Committee of the Whole House / Third reading of the Bill stage.
20 December 2010	Bill receives the Royal assent.
23 December 2010	Policy Advice Division of Inland Revenue ('PAD') issues special reports on LTC rules and QC changes.
1 April 2011	New LTC regime and amended QC rules commence.
14 September 2011	Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill introduced, which contains amendments to LTC rules.
27 September 2011	First reading of Bill.
6 June 2012	FEC reports back on Taxation (Remedial Matters) Bill.
2 August 2012	Second reading of Bill.
16 October 2012	Parliamentary debate: Committee of the Whole House
25 October 2012	Third reading of Bill.
2 November 2012	Bill receives the Royal assent.
8 September 2015	Release of Officials' Issues Paper "Closely held company taxation issues".
2 December 2015	Release of Regulatory Impact Statement "Review of closely held company taxation".

3 May 2016	Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill introduced.
15 June 2016	First reading of Bill.
24 November 2016	FEC reports back on Taxation (Closely Held Companies) Bill.
9 March 2017	Second reading of Bill.
14 March 2017	Parliamentary debate: Committee of the Whole House.
23 March 2017	Third reading of Bill.
30 March 2017	Bill receives the Royal assent.
1 April 2017	Amended LTC regime commences.

2 *The Resulting Regime*

The LTC regime applies for income years commencing on or after 1 April 2011.[44] A LTC is transparent for tax purposes, with income, expenses, gains, losses, tax credits and rebates passing through to the shareholders and being taxed at the shareholders' marginal tax rates.[45] Some tax matters are dealt with at the company level such as GST, PAYE and other withholding taxes and matters related to the amalgamated companies regime.[46] As income tax is not payable at the company level, imputation accounts are not required to be kept.[47]

A LTC must have only one class of shares. While the LTC must be a resident in New Zealand for tax purposes, there is no requirement that the shareholders be New Zealand tax residents. Notably, a LTC can only have five or fewer 'look-through counted owners', with relatives being counted as one owner. Look-through counted owners can only be natural persons, trustees or another LTC. A company that is not a LTC is not able to be a shareholder in a LTC.[48]

Further, in order for a company to meet the definition of 'look-through company', it must have no more than $10,000 of foreign-sourced income. This restriction applies only if more than 50 percent of the LTC's ownership interests are held by foreign LTC holders.[49]

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[44] *Income Tax Act 2007* (NZ) sub-pt HB.

[45] Ibid s HB 1.

[46] Ibid.

[47] Ibid s OB 1.

[48] Ibid s YA 1.

[49] Ibid.

3 *Subsequent Changes and Amendments*

Considering the lack of public consultation and scrutiny, it is hardly surprising that there have been many legislative changes to the LTC regime since its inception. For example, the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill in 2011, introduced a raft of amendments, covering things such as QC amalgamations, tax elections, valuation and timing methods and the look-through counted owner test.[50] Major overhauls to the LTC regime were enacted with the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Act. The main changes were the removal (in most instances) of the loss/deduction limitation rule (on the basis it gives rise to undesired complexity) and changes to entry criteria.[51] As well as these, there were a range of measures aimed at decreasing compliance costs for taxpayers that use LTCs. Most of these changes took effect from 1 April 2017.

III METHODOLOGY

This research utilises interviews with tax practitioners in conjunction with documentary analysis.[52] Tax practitioners have been used as a sample due the important role they play within the tax system. That is, tax practitioners provide a link between taxpayers and the revenue authority.[53] Because of this, the services provided by tax practitioners have a substantial impact on taxpayer's voluntary compliance. Additionally, tax practitioners have an impact on the minimisation of both compliance and administrative costs for taxpayers.[54] This is due to tax practitioners having a greater knowledge of tax laws and procedures than that of the average taxpayer.[55] Accordingly, tax practitioners are often regarded as "gatekeepers" to the tax system

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[50] The look-through counted owner test was narrowed in order to prevent trusts from being used to bypass the shareholding restrictions. Specifically, distributions of beneficiary income now need to be traced for the purposes of establishing the number of 'look-through counted owners'.

[51] *Income Tax Act 2007* (NZ) s HB 11. Previously, the loss limitation rule required each shareholder in the LTC to calculate their 'owner's basis'. Broadly, this reflects the economic contribution to the LTC by that respective shareholder. If the losses attributed to a shareholder exceeded their owner's basis, then a deduction was disallowed. From 1 April 2017, this rule only applies to LTCs in partnerships or joint ventures.

[52] See also John Scott, *A Matter of Record: Documentary Sources in Social Research* (Polity Press, 1990).

[53] Ranjana Gupta, 'Relational Impact of Tax Practitioners' Behavioural Interaction and Service Satisfaction: Evidence from New Zealand' (2015) 13(1) *eJournal of Tax Research* 76.

[54] Brian Erard, 'Taxation with Representation: An Analysis of The Role of Tax Practitioners in Tax Compliance' (1993) 52(2) *Journal of Public Economics* 162.

[55] Steven Kaplan et al, 'An Examination of Tax Reporting Recommendations of Professional Tax Preparers' (1988) 9(4) *Journal of Economic Psychology* 427.

for taxpayers.[56] To this end, the views of tax practitioners are invaluable in evaluating the LTC regime, especially from a compliance cost perspective.

A *Semi-Structured Interviews*

The primary research method utilised was semi-structured interviews, which were undertaken during 2017. This was considered to be the most appropriate method, as the research was concerned with practitioner's perspectives on the LTC regime. That is, interviews allow rich data to be gathered from people in various roles and situations.[57] Other methods of data gathering, such as questionnaires, would likely mean that rich data would not be gleaned from participants. An additional advantage of interviews is that follow-up questions could be asked, resulting in further insights being revealed to the researcher.

B *Interview Guide Development*

An interview guide was also used to ensure any topics or areas were not overlooked. The interview guide was flexible, and whilst there were set sections, the order of questions was fluid. This paper draws on four sections from the interview guide: 'Use of the LTC regime', 'Advantages of the LTC regime', 'Disadvantages of the LTC regime' and 'Complexity of the LTC regime'. As well as this, the interview guide evolved as interviews occurred. That is, it was tweaked and updated as interviews progressed. Additionally, the interview guide was piloted with the author's previous employer who is a tax practitioner, with the pilot responses providing further avenues for exploration and consideration.

C *Sample Selection*

This research utilised a broad definition of tax practitioners, where tax practitioners were deemed to be tax preparers, tax accountants, tax lawyers and tax agents, provided that they held membership of a professional body (such as Certified Practicing Accountants ('CPA'),

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[56] Peggy Hite and Gary McGill, 'An Examination of Taxpayer Preference for Aggressive Tax Advice' (1992) 45(4) *National Tax Journal* 389; Kaye Newberry, Philip Reckers and Robert Wyndelts, 'An Examination of Tax Practitioner Decisions: The Role of Preparer Sanctions and Framing Effects Associated with Client Condition' (1993) 14(2) *Journal of Economic Psychology* 439; Lin Mei Tan, 'Taxpayers' Preference for Type of Advice from Tax Practitioner: A Preliminary Examination' (1999) 20(4) *Journal of Economic Psychology* 431.

[57] Michael Myers, *Qualitative Research in Business & Management* (Sage, 2009).

Chartered Accountants Australia and New Zealand ('CAANZ'), and the New Zealand Law Society).

Tax practitioners were recruited with the assistance of Peter Vial, who was, at the time, the New Zealand Tax Leader of CAANZ. Peter Vial identified a number of potential interviewees and an individual email was sent to each with information on the research and a consent form. Human Ethics approval was gained from the University of Canterbury.[58] Responses were received from 4 practitioners, whom all agreed to participate in the research. Accordingly, the researcher sought to identify and recruit further participants. This was done predominately through a search on Google using key words to identify tax practitioners that had relevant experience. This resulted in nine more tax practitioners agreeing to participate in the research, with each of these participants receiving the same email as the other 4 practitioners.

Accordingly, the sample of tax practitioners was composed of 4 practitioners recruited through 'snowball' sampling. That is, participants were recruited using one contact.[59] Snowball sampling is advantageous in that it is a low-cost solution allowing participants to be found easily and quickly, especially from a specific population.[60] However, snowball sampling can lead to various types of sampling bias and can make generalisation difficult.[61] These limitations were overcome by the use of purposive sampling to recruit the other 9 participants.

A total of 12 tax practitioners were interviewed in their professional capacity. Three practitioners were located in Wellington, two were located in each of Auckland, Christchurch and Dunedin, and one was located each in Tauranga, Napier and Blenheim. Of these practitioners, nine were partners/directors and one was a tax manager. Two interviewees were members of the independent bar.[62] Additionally, one tax practitioner provided email responses to the interview guide, providing a total of 13 usable responses. The firms employing these

58 The author wishes to note that data was collected as part of a Master of Commerce thesis that explored look-through companies from a tax practitioner's perspective.

59 Alistair Geddes, Charlie Parker and Sam Scott, 'When the Snowball Fails to Roll and the Use of 'Horizontal' Networking in Qualitative Social Research' (2018) 21(3) *International Journal of Social Research Methodology* 347.

60 Ibid.

61 Ibid.

62 This bar comprises lawyers who practise as 'barristers sole'. Barristers sole are not permitted to practise in partnerships, but may employ other barristers. Applicants must have had at least three years' legal experience in New Zealand during the preceding five years before applying for the independent bar.

practitioners were a mix of Big 4 firms, mid-tier firms, specialist tax consultancy practices, tax barristers and small accounting firms. This provided a number of different perspectives. After thirteen responses, saturation of information occurred; no new information or themes were observed from the final interviews.

D *Data Collection Procedures*

As stated above, a consent form was issued to all participants and returned prior to each interview commencing. Interviewees were given a chance to ask any questions prior to the interview. Additionally, interviewees were free to withdraw from the research at any time. Prior to the interviews, interviewees were asked if they consented to being recorded with an audio-recording device. Each of the interviews was transcribed by the author within approximately a week of completing that particular interview. Alongside audio recordings, brief notes were taken by the author during the interviews.

The majority of the semi-structured interviews were conducted over the phone. One interview was conducted face-to-face at the practitioner's office. Interviews were conducted with 12 tax practitioners, with each being 30 to 90 minutes in length. One email response was received, resulting in 13 usable responses. Whilst phone interviews have disadvantages (for example, the researcher cannot gauge body language), this was the most practical method given that the interviewees were located in various parts of New Zealand.

E *Data Analysis*

Once the interviews were transcribed, the author analysed them with a view to identifying trends and themes. Specifically, thematic analysis was undertaken with the assistance of NVivo, a qualitative data analysis software package. NVivo allows the researcher to highlight common themes and trends in interview responses. Conflicting viewpoints were also noted.

F *Documentary Analysis*

This research also utilised documentary analysis to establish the rationale behind legislative changes and the implementation of the LTC regime. Accordingly, the vast majority of documents analysed were public documents such as Acts of Parliament and officials' reports. Documents were assessed using the four criteria suggested by Scott:[63] authenticity, credibility,

[63] Scott (n 52).

representativeness and meaning. Whilst public documents are authentic and have meaning (they are clear and comprehensible to the researcher), the other two criteria may require greater thought.[64] In regard to representativeness, this is not as important in qualitative research as no case can be representative in a statistical sense.[65] In terms of credibility, public documents have the potential to be biased, as they are prepared by institutions for specific purposes. This bias can reveal interesting insights, but the researcher must also be cautious as these documents may not be true depictions of reality. By combining documentary analysis with interviews, triangulation helped the researcher gain greater insights.

IV RESEARCH FINDINGS

This chapter introduces the findings from the interviews with tax practitioners. The findings will be compared amongst interviewees, with a view to revealing common themes and views. This will provide a basis for Chapter 5, which will set out the discussion and analysis of the findings outlined in this chapter.

A *Use of LTCs*

1 *Typical Uses*

As a starting point, the researcher sought to determine typical scenarios where the LTC regime might be utilised. Answers varied between tax practitioners; there did not appear to be a consensus on what a typical use might be. An example that highlighted this was using LTCs as a holding vehicle for rental property. Some practitioners felt that the LTC regime was useful in this context:[66]

> The classic use is to hold rental properties, particularly residential rental properties, and many people transitioned into that regime from the old LAQC. (Practitioner J)

> And probably residential rental type properties. Obviously for residential rental properties they often run at a tax loss, that means that the losses are attributed up to the individuals and they get to offset it against their salary and get a bit of a tax break there. (Practitioner A)

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64 Alan Bryman and Emma Bell, *Business Research Methods* (University Press, 2015).

65 Ibid.

66 Rental property losses are now ring-fenced. That is, they generally cannot be offset against income from other sources.

However, a number of practitioners were of the view that LTCs were not ideal as a vehicle for holding rental property. The reason for this was that other structures were often easier or provided more tax advantages:

> We did have rental properties [that we] started putting them into LTC's but because of some of the problems of the LTCs we've actually backed away and just find now if you've really got rentals it's just as easy to leave it in your own name or as a partnership. We're backing those out. (Practitioner I)

> I really do question – people will go off and buy rental properties, do they have to be in an LTC? Well, no. There's different ways you can structure your rental property investments. Not using look-through companies. You don't need a look-through company for rental properties. You can get the same [treatment] if you have it in your own name, and then don't have the complexity with a company. (Practitioner D)

Practitioner A noted that rental properties often did not make losses since the removal of depreciation on buildings in 2010,[67] and as such, did not have a need for such a structure:

> And the only thing tax change, in recent times that has impacted on the residential rental property…was removing depreciation on buildings. (Practitioner A)

Some practitioners were of the view that the LTC regime was best used for businesses anticipating losses (other than companies with rental properties), such as those in the start-up phase or vineyards:

> So it's really rental properties or companies with an expectation of loss certainly in the early three or four years, or first three or four years that we see. The LTC structures that we know it's driven by loss. And, you know, it's an interesting discussion that isn't it? Because outside the rental properties there's not very many businesses you expect to run at a loss, but sometimes it's that thing or that initial period of "we're going to run at a loss." (Practitioner K)

> Up here in Marlborough it's mostly vineyards. They're perfectly suited for that, where you're going to have losses for properties five to seven years minimum while you're setting the thing

[67] As part of the New Zealand Government's COVID-19 relief measures, depreciation has now been reintroduced for commercial buildings.

> up and then down the track hopefully you'll make some money. For us it's mostly vineyards. (Practitioner I)

In addition to companies anticipating losses, practitioners perceived the typical use of the LTC regime to be for small and/or family-owned businesses:

> Obviously with the limitation on number of shareholdings, it is usually smaller, family-owned, well not necessarily family-owned but can be family-owned, or businesses that are one to two or three non-associated individual partners. (Practitioner B)

> From a design perspective, it was originally aimed at small businesses, so your electricians, your plumbers, your builders, and that sort of thing. (Practitioner A)

Another notable use of the LTC regime is for international tax planning and structuring.[68] Practitioner L outlined a specific situation where LTCs were useful in an international context:

> I've got one LTC where the guy does contracting work in Ireland. We're using an LTC just because of the limited liability it gives us. We're looking at individual ownership, which eliminates double taxation versus a corporate, which would impose double taxation, so certainly the LTC sits nicely in the middle and gives us the best of both worlds depending on how it's looked at in a foreign jurisdiction. (Practitioner L)

Other practitioners, including Practitioner F and Practitioner G, also shared the view that the LTC regime was useful in an international context:

> We've seen a few foreign things in the context with foreign trusts as well. Where they're operating using New Zealand as a tax haven for foreign investments effectively. Sometimes a look-through company could've been used in that context. (Practitioner F)

> And then on the other extreme, I have clients who have businesses in foreign jurisdictions and they have used look-through companies for that. (Practitioner G)

1 *Reasons for Use*

Because various practitioners viewed the LTC regime as being used for different purposes and situations, the reasons for use also vary. However, the most common reason for using the LTC

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[68] At the time of these interviews, there was no cap on the foreign sourced income a LTC could receive.

regime was stated by practitioners to be the fiscal transparency that the structure provides. That is, the requirement that losses and profits flow through to the shareholders of LTCs:

> There are a few reasons. The first, the most obvious one, is if they want to hold an investment or a business in a company structure, but they're anticipating losses in a reasonably regular fashion, just from the nature of it, or tax losses at least, not necessarily economic losses, but tax losses being the benefit is that the losses flow through to the shareholders. (Practitioner B)

Of note is that some practitioners viewed the fiscal transparency of LTCs as being a disadvantage, which is discussed further on. Alongside fiscal transparency, some practitioners viewed limited liability as being important. Practitioners I and M were of this view:

> If you're running a vineyard there are risks involved. So they want limited liability but obviously if you're looking at generally seven years of losses in the vineyards before you start making any money. You want to be able to, well you have to access that loss usually to fund the thing. That's the biggest reason for using an LTC. (Practitioner I)

> But at the same time, clearly if you can get access to losses that's an efficient way of using a corporate structure but still getting the tax effect of a partnership, or even sometimes I guess the advantages are that you still get your look-through treatment so it is still actually treating you as a partnership from a tax perspective but a corporate from a commercial perspective. (Practitioner M)

Practitioner D provided a different view, as they considered limited liability to often be the sole reason for the use of the LTC regime:

> So, I have seen an orthopaedic surgeon with a look-through company because that means that they're just effectively doing what they do as if they were self-employed but with limited liability. And there are no tax savings in that; it is absolutely a commercial claim. (Practitioner D)

Conversely, some practitioners did not view limited liability as being important in deciding whether to use the LTC regime:

> The biggest liability for a property owner is the bank or the liability of the bank that's personal anyway through the personal guarantees that they give to the bank. So asset protection in my view, I don't think people would see an LTC as offering any major asset protection. (Practitioner C)

> The point I was making about limited liability is that when it comes to a small business, very often suppliers, and particularly banks, want personal guarantees from shareholders. Limited liability is a little bit more of a perceived notion than a real opportunity if you like. (Practitioner H)

Practitioners indicated that in an international context, the LTCs regime is used to help minimise double taxation. This is mainly due to the attributes of fiscal transparency and limited liability mentioned previously:

> If they're operating in foreign jurisdiction they're able to eliminate double taxation if they use a vehicle like an LTC, which benefits because in the overseas jurisdiction the LTC is simply seen as a corporate, so tax liabilities, generally speaking, are taxed at a fixed rate, at a corporate rate in that jurisdiction and then, when it comes to New Zealand, they get their share of income and expenses plus their share of the foreign tax credit, which is beneficial. (Practitioner G)

> If I'm a New Zealand resident individual and I'm investing in Australia, for example, and there's no corporate formed there yet, then having an LTC could make quite a lot of sense. If you had a company there, you'd pay tax on income in Australia. If you had a company there, you would lose the tax credit when it came through and you were distributing out to the shareholder, whereas if you've got an LTC, that doesn't happen. (Practitioner F)

Practitioners also mentioned that one of the reasons that the LTC regime was used was because the rules surrounding the regime allowed tax-free distributions to shareholders[69] and the ability to minimise tax on historic retained earnings:[70]

> The other possibility, the other one that we've used it a bit more for is as a means of ensuring that distributions are tax-free, without having to go through liquidation. If I had a farm and I sold a block, for example, then in order to get that money out, and it was a capital gain, in order to get that money out tax-free I'd have to liquidate the company. (Practitioner F)

> Yeah, so if I had a company and I've had several circumstances, one in particular where they had, believe it or not, 30 million dollars-worth of retained earnings. So roughly 45 million dollars-worth of profit built up over time, with 15 million dollars-worth of imputation credits. So, if they paid a dividend out of that company, they would have had gross income, gross dividends of 45 million and 5% withholding tax on that, so about 2.2 million of withholding

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69 This arises as shareholders are treated as holding the LTC's property in proportion to their effective look-through interests.

70 *Income Tax Act 2007* (NZ) s CB32C.

> tax. Under the LTC rules, if you enter the LTC regime and you've got fully imputed retained earnings there was no cost to enter. You were able to escape 5% withholding tax. (Practitioner A)

One final reason for their use mentioned by practitioners was that many taxpayers viewed the LTC regime as a default replacement for the LAQC/QC regime, and as such, chose to transition into the regime:

> Look with the smaller clients because, generally speaking, most of them were within the qualifying company regime and, when the LTC came through it just seemed sensible for them to roll over. For those sort of clients, I think little thought was put into whether they should or not. (Practitioner G)

> I think a lot became LTC's by default and as in, people transferred from what was the LAQC regime to LTC's so I think there were a lot of LTC's who perhaps ought not to have been. (Practitioner M)

2 *Recommendation of Use and Taxpayer Knowledge*

Tax practitioners stated that in almost all circumstances, it was they who recommended clients use the LTC regime. Practitioner J provided an example of this view:

> Mostly we're the ones who are driving it in terms of a choice of structures. If somebody is setting up an entity in the first instance, alternatively, and we've got a few of these on the books at the moment, where people are looking to restructure their businesses to be able to get assets out or to try and get gains out and so forth. It often turns out that the best answer in terms of the viable options is to convert an ordinary company into an LTC effective from the beginning of the next tax year, and do these things at the least possible tax cost. That is often us who is driving it. (Practitioner J)

It was only in a small portion of instances clients requested to utilise a LTC, or showed interest in forming one:

> You know, they've been talking to people at the pub who say they've got a rental property and a look-through company, why haven't you? But there tends to be a relatively uninformed view, so it would tend to be our recommendation or our advice, which either puts them in or doesn't put them in. (Practitioner L)

> I have had a client who comes in and says, "I would like to explore an LTC." So, they've got the idea from somewhere and they just want to make sure that it works. That's another way that they might raise it. (Practitioner F)

However, practitioners were of the view that clients generally had very low levels of knowledge on LTCs, regardless of whether clients utilised them or not. Practitioner H responded with this when asked if clients had good levels of knowledge on the LTC regime:

> No. Not at all. If you happen to operate via an LTC you need an accountant. And you probably need a tax accountant. (Practitioner H)

In fact, practitioners stated that many clients know more about the LAQC/QC regime than the LTC regime, even though the LAQC/QC regime has been repealed for over five years at the time of research:

> I've been in so many meetings where I have mentioned an LTC, blank look, I can then refer to an LAQC, which has been gone for what, five or six years, and people still know it. (Practitioner K)

> A lot of people are still getting their heads round LAQCs, but things have moved on from that five years ago, six years ago. (Practitioner C)

3 *Popularity*

Practitioners also held mixed views on the popularity of the LTC regime. Practitioner D stated that LTCs were not popular in their practice:

> Now you can probably count on one hand the number of LTC clients we've had in our office. If I said we had 600 corporate clients, less than one percent of them are in the LTC rules. (Practitioner D)

Practitioner L and M shared this view:

> We tend to use them in limited circumstances. So, we've got 1000 tax returns, and best guess, we do 33 LTC returns. (Practitioner L)

> I don't know that the LTC regime was popularly used by our firm at all. So, I don't know if its necessarily now considered to be the most popular of structures, its used, [but] there's better options I guess (Practitioner M)

Conversely, some practitioners believed that the LTC regime was popular. Practitioner A was of the view that most LAQCs chose to transition to into the LTC regime:

> So, most taxpayers, I would hazard a guess, 95% of LAQCs would've transitioned to look-through companies. (Practitioner A)

However, practitioners were generally of the view that the LTC regime was not as popular as the LAQC regime:

> I don't think they're as popular, certainly not in my understanding popular as maybe LAQCs were. (Practitioner C)

> They're not as popular as the LAQC regime. We've got just over 100 LTCs but still got 250 QCs left. We would have had about 500 LAQCs in the hey-day. Some exited when they changed the rules. Some went the QC, some went the LTC. (Practitioner I)

B *Advantages of LTCs*

1 *Overview of Advantages*

The advantages of the LTC regime overlap with the reasons that practitioners use the structure. These were discussed in the previous section, and included fiscal transparency, limited liability, minimising double taxation in an international context, distributing tax-free capital gains and minimising tax on historic retained earnings. Alongside these advantages, practitioners also indicated other advantages of the LTC regime, such as simplicity and the ability to use a LTC to maximise interest deductibility.

2 *Simplicity*

Another advantage posited by some practitioners was simplicity of administration. Practitioner J and K were of the opinion that a LTC is simpler than a traditional company in some aspects:

> There's probably a bit of an ease of administration that you don't have to muck around with imputation credits and RWT when making distributions. (Practitioner J)

> It does simplify some of those things otherwise you see around FBT or overdrawn current accounts. (Practitioner K)

3 *Separation and Interest Deductibility*

Practitioners were of the view that an advantage of the LTC regime was the ability to use them to restructure affairs. A LTC can allow separation between taxpayers private and business matters, and can thus maximise interest deductibility.

> But I suppose the other major advantage is that we have a lot of clients when they want to restructure their affairs, let's say they have a rental property in their personal name that is not very highly geared, and they want to buy a new family home, and it's going to involve more borrowing, so what we typically do, and you're probably aware of this, is you might establish a look-through company, transfer the rental property to the LTC, and make that 100% geared and then use the equity that you have in the rental property to put into your private residence. And say you're essentially making some of that debt, which would have otherwise been private non-deductible; you're turning it into tax-deductible debt. (Practitioner A)

> For example, in terms of our deductibility of interest where people restructure their private home and their rental property maximises interest deductions into an LTC structure and whether that works. (Practitioner J)

C *Disadvantages of LTCs*

1 *Overview of Disadvantages*

As well as advantages of the LTC regime, practitioners were also of the view that there were a number of disadvantages of the LTC regime. These included the loss/deduction limitation rule, the requirements regarding who can be owners, the inability to quarantine profits or losses in the company, shareholder changes, transparency of LTCs and poorly/ambiguously drafted legislation. Each will be discussed in more detail below.

2 *Loss/Deduction Limitation Rule*

The most common disadvantage mentioned by practitioners was the loss/deduction limitation rule, and the associated owners' basis test. Almost all the practitioners had a negative view of the rule:

> The drawback of the regime, if you're speaking about today, loss limitation rule or deduction limitation rule would be the most significant drawback and the biggest impediment to entry into the regime. (Practitioner L)

> The loss limitation rule. Which is essentially, you're only supposed to get losses to the extent of your equity in the investment. Your owners' basis. And that's been a complete balls up from day one. (Practitioner A)

However, Practitioner B did not view the loss/deduction limitation rule as being a disadvantage of the regime:

> A lot of people tried to predict that there would be a lot of disaster and a lot of doom and gloom with that loss limitation rule in practice, but I never saw that. I never envisioned it would actually be a big problem from that. I never saw it in practice. (Practitioner B)

3 *LTC Eligibility Requirements*

Practitioners also mentioned the LTC eligibility requirements as a disadvantage of the structure. Practitioner D thought that the restriction on five-counted owners was a disadvantage:

> Effectively, because there was Mum, Dad, and the family trust and the other Mum, the other Dad, the other family trust, or whatever and something was going on with the particular fact pattern. They couldn't bring in a new shareholder because they're going to lose their look-through company status. (Practitioner D)

Practitioner I was also of this view:

> Yeah, which is not ideal and really what is the point having five because you can structure around it. But you're just incurring more accounting and legal costs. They'd be the only real bug-bear I'd see left there actually to be honest. (Practitioner I)

Practitioner M also thought this was a disadvantage, along with the requirement that LTC owners are New Zealand tax residents:

> Because of course there's a limitation on the number of people that limits the kind of industry and those businesses that can use the regime in any event. Because of the New Zealand registered requirements, or the New Zealand tax resident requirement, that also limits the scope of it. (Practitioner M)

4 *Unable to Quarantine Profits or Losses*

Due to LTCs being fiscally transparent, profits and losses cannot be quarantined in the company. Instead, they must flow out to shareholders in proportion to their owners' basis.

Some practitioners viewed this as a disadvantage of the LTC regime. Practitioner H thought this was a disadvantage as shareholders were potentially subject to a tax liability:

> Oh absolutely. I mean because they're taxed as partnerships, you've then got personal tax liabilities in the shareholder name. For example, if it was an ordinary garden variety company that had a tax liability and it couldn't pay that tax, then in most circumstances, Inland Revenue couldn't seek redress from the shareholder. Whereas with an LTC, the liability for tax rests with the shareholder individually. (Practitioner H)

Other practitioners viewed the inability to quarantine profits and losses as a disadvantage because of the differences in the top marginal tax rate (33%) and the company tax rate (28%):

> Well, it's not possible to accumulate income at the corporate tax rate, flow-through aspects of it, so if the shareholders are fairly well heeled, then they're essentially paying tax at their top marginal tax rate rather than be able to accumulate income at a lower tax rate. That's often perceived to be the main disadvantage. (Practitioner J)

> Now that'll be 33% to individuals and trusts or you can accumulate your retained earnings within the company and you'll pay taxes at 28% corporate rate if it's not a look-through company and that 5% can get reinvested in the business. (Practitioner D)

5 *Shareholder Changes*

Some practitioners also mentioned shareholder changes as being a disadvantage of the LTC regime. Shareholder changes can trigger a deemed sale and repurchase of the LTC's assets at market value, which often has negative tax implications:

> There's also the issue with when the shareholder exits, as you'll know you've got a deemed sale of underlying assets. Generally, the $50,000 exemption, and the $200,000 dollar fixed assets threshold gets most people out but not all. So that can be a problem. (Practitioner I)

> Of course, with an LTC you've got the deemed sale of all the underlying assets and you've got these issues around dividends that are paid out of retained earnings earned while the company is an LTC but distributed after it ceases to be an LTC, they can still be exempt, you know. (Practitioner A)

Practitioner D was of the view that shareholder changes required LTCs to keep multiple sets of accounts, to reflect that each shareholder has a different cost basis. This resulted in increased complexity:

> And if you do have a deemed disposal, you know if you're outside of that, eight thousand de minimis, you end up in a situation where ... you effectively keep two sets of books? You know the company's accounts because the Companies Act says it has to, and then you'll have Shareholder A, who was an original one at the time that it went in. So, Shareholder A could piggyback off the company accounts. But if you came into the office today and bought out Shareholder B and you'd get all the plant based on today's market value et cetera. And the IRD forms don't even lend themselves to that because the IR7s think, "Oh you're 50/50 shareholders in the LTC that means you get half." No, because the cost of my half might be different than the cost of Shareholder A's half. (Practitioner D)

6 *Transparency*

Some practitioners were of the view that the transparency of the LTC regime itself was a disadvantage. This transparency often created confusion, as practitioners were unsure how far this transparency extended. Practitioner D used an example of working owners to highlight this view:

> Now there's some funny stuff goes on and they've got some particular provision in the rule that gives a deduction for payments to working owners. The IRD was saying that four shareholders, four cars, you just claim private business use on each vehicle cause that's transparent. It's as if you're self-employed now. And that's a fallacy. You are not self-employed. You're not self-employed. You are deemed to do the things that a look-through company does in the proportions of your own share. (Practitioner D)

Practitioner J referred to 'one-way' transparency, where the tax treatment differed and was not consistent across different circumstances:

> Yeah, well just how that works in terms of the IRD's almost invented this notion that, "Yeah. Okay. You're deemed to hold these assets in your name but we're going to treat that as being held in a different capacity, as if you're the shareholder of the LTC as opposed to your personal capacity," which almost seems like dancing on the head of a pin. I can understand why they have to do that, otherwise there'll be some funny tax results going around, but that lacks a little bit of clarity there, particularly when you're trying to explain that to people. (Practitioner J)

7 *Poorly Drafted and Ambiguous Legislation*

A final disadvantage raised by practitioners was the belief that legislation associated with the LTC regime is poorly drafted and ambiguous. Practitioner F was of the view that the legislation created uncertainty:

> Yeah, so I think that's the main drawback of it. There's quite a bit of uncertainty. It goes to things, for example, about contributing property into the LTC. What is the consequence of that? If I have two people who have put property into an LTC or into a partnership, are they deemed to have realised 100% or 50%, 50/50% partners. And then what's the depreciation base? These are pretty elementary, really elementary questions for which there should be absolute certainty, but there is not. (Practitioner F)

Practitioners D and G shared this view:

> Now, part of the reason for that is that the rules are so badly, and I say that with capital letters, badly written and so there are some parts of the rules that you just roll your eyes and think that's stupid. (Practitioner D)

> Yes, I would. Maybe 'poor' is the wrong word, but unnecessarily complex is probably appropriate because things like working out owner's bases, I think if you talked to anyone, any practitioner who's actually invested the time in doing it, I mean it's, you'd think it was rocket science you know. (Practitioner G)

D *Complexity of LTCs*

When practitioners were asked if the LTC regime was complex, the majority of practitioners were of the view that they were:

> That I think is a drawback in the sense in that the fundamentals of the regime are not easy. (Practitioner F)

> They are probably more complex than any other structure. Certainly of other company QCs, partnerships, I'd rank the LTCs the most complicated. (Practitioner I)

> And I guess the other part of the LTC regime is it's complex to apply. I don't use them at all because I think they're too bloody complicated. (Practitioner H)

However, Practitioner B did not believe the LTC regime was normally complex:

> Not really in most cases. If you're trying to ... if you're on the, I wouldn't say the edge, but if you're in an area that it isn't necessarily done all the time in terms of look-through counted owners or a partnership of LTCs than it can be somewhat complex, but most of the time it's not particularly complex.

Practitioners who thought the LTC regime was complex gave differing reasons in support of their view. The most common reasons given were the loss/deduction limitation rule and the quality of the legislation. For example, Practitioner F was of the view that ambiguous and poor legislation resulted in the regime being complex:

> Essentially because they've been lazy in the craftsmanship of the legislation, and haven't provided for the results, but have tried to do it by way of a set of general principles but without great clarity around how each of them interact and which ones prevail when. (Practitioner F)

Conversely, Practitioner A was of the view that complexity resulted from the loss/deduction limitation rule and the need to calculate owners' basis:

> A lot of accountants are now steering away from LTCs because the compliance, particularly the owners' basis crap is too onerous and costs the taxpayer too much. (Practitioner A)

V ANALYSIS AND RECOMMENDATIONS

A *General Analysis*

1 *Use of LTCs*

The intended target market of the LTC regime is small family businesses. Whilst some practitioners indicated that small family businesses used the LTC regime, there were also a number of uses stated by practitioners that did not seem to be contemplated by Parliament and Inland Revenue. These other uses included rental properties, companies anticipating losses and international tax structuring and planning. As mentioned above, another reason mentioned by the Valabh Committee in recommending the QC/LAQC regime was to reduce taxation's role in the choice of which business entity to use.[71] However, uses such as rental properties, companies anticipating losses, and international tax structuring and planning, utilise the LTC regime solely for its taxation characteristics.

[71] Valabh Committee (n 25).

Practitioners also indicated that it was they who recommended clients use the LTC regime, and that clients had very low levels of understanding surrounding the LTCs regime. Due to its target market of small family businesses, it would be reasonable to expect that these clients would have some sort of knowledge of a regime specifically targeted towards them. Practitioners indicated that clients instead had higher knowledge levels in regard to the LAQC regime, even though this had been repealed for over six years at the time of the research. This is likely to be due to the level of media coverage surrounding the use of the LAQCs up until their eventual repeal.

Whilst Parliament and Inland Revenue have provided a specific structure for this target market, they have not promoted and educated this target market. In hindsight, this may have resulted in a higher uptake of the LTC regime.[72]

Practitioners also provided various reasons for why the LTC regime is used. The most common reason given for using the structure was the fiscal transparency that the structure provides. There was no consensus from practitioners on whether limited liability was important in deciding whether to use or recommend the LTC regime. Notably, only limited partnerships offer limited liability and tax flow-through treatment, alongside the LTC regime.[73] Practitioners gave other reasons for using the LTC regime, but these were not consistent across the majority of practitioners. These included minimising double taxation, tax-free distributions to shareholders, and minimising tax on historic retained earnings.

2 *Advantages of LTCs*

In addition to the advantages discussed above, practitioners also stated that the LTC regime had other benefits. These included simplicity, separation and interest deductibility. The perceived advantage of simplicity aligns with the policy rationale for the LTC regime. Because the LTC regime is aimed at small family businesses by nature, it should be simple and easy to apply. This is because small family businesses are resource constrained, especially when compared to large businesses. However, very few practitioners were of the view that the LTC

[72] At the time when the LAQC regime was repealed, there were over 130,000 LAQCs in existence. In comparison, the Government Tax Working Group stated that there were approximately 48,000 LTCs in existence at the time of their review. See, eg, Tax Working Group, *Background Paper for Sessions 6 and 7* (March 2018) <https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-appendix-1--types-of-business-entities-in-new-zealand-and-how-they-are-taxed.pdf>.

regime is simple, mainly due to the loss/deduction limitation rule and the associated owners' basis test. In regard to separation and interest deductibility, these do not appear to have been contemplated by Parliament. However, it is important to note that these benefits can be achieved using other structures.

3 *Disadvantages of LTCs*

Practitioners were of the view that there were a number of disadvantages of the LTC regime. The most commonly mentioned disadvantage was the loss/deduction limitation rule and the (now repealed) associated owners' basis test. This resulted in unnecessary complexity, and thus compliance costs. The next most common disadvantage mentioned by practitioners was the LTC eligibility requirements. To ensure that closely held companies are used by their intended audiences, there is a limit on the number and the types of shareholders. Whilst this was perceived to be a disadvantage by many practitioners, this is arguably a prerequisite for a closely held company regime. Further advantages include the complexities associated with shareholder changes, as well as issues surrounding transparency; it is unclear as to exactly how transparent LTCs are and in what circumstances they are or not to be 'looked-through'.

4 *Complexity of LTCs*

When the QC/LAQC regime was implemented, one of the stated intentions was to simplify taxation for small, closely held companies by treating them the same, regardless of their legal structure.[74] Ultimately, this would result in lower compliance costs. Due to LTC regime being the successor to the QC/LAQC regime that simplification of taxation is also a policy intention for the LTC regime.[75] However, the majority of practitioners were of the view that the LTC regime is complex, especially when compared to structures such as sole traders, partnerships and traditional companies. Practitioners believed that LTCs were complex for two main reasons, one being the loss/deduction limitation rule. This has now been repealed for all LTCs except for those in partnership or joint venture.

The other reason practitioners believe the LTC regime is complex is due to poor quality legislative drafting. This has also been recognised by Inland Revenue, who drafted the

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[74] Valabh Committee (n 25); Inland Revenue Department (n 26).

[75] Inland Revenue Department, *Regulatory Impact Statement - Review of Closely Held Company Taxation* (2015).

legislation, and there have been a multitude of amendments to the legislation associated with the LTC regime since enactment. However, many of these amendments have been practitioner instigated through submissions and consultation with Inland Revenue. Notably, some practitioners were of the view that this low quality legislation was a direct result of Parliament implementing the LTC regime through Supplementary Order Paper 187. This occurred at the third reading of the Bill, and as such only very limited consultation was sought from practitioners. If the LTC regime had instead gone through the GTPP, then it is highly likely that better legislation would have resulted.[76]

Previous literature has indicated that flow-through entities such as the LAQC regime and the LTC regime result in unavoidable complexity (and thus compliance costs), especially when compared to traditional structures.[77] This sentiment appeared to be shared by the practitioners interviewed.

B *Adam Smith's Canons of Taxation*

In the context of compliance costs, the most relevant of Adam Smith's canons of taxation are certainty, convenience and economy.[78] Certainty is the idea that the taxpayers should be able to ascertain the amount of tax that is required to be paid and when. Additionally, taxes should not be arbitrary in nature.[79] Convenience is the concept that taxes should be readily and easily assessed, collected, and administered, which ensures compliance.[80] Finally, economy concerns collecting tax with the lowest amount of cost.[81]

The findings above indicate that the LTC regime is problematic in respect to each of these canons. That is, the LTC regime gives rise to uncertainty through vague and ambiguous legislation. Whilst the changes in 2017 have gone some way to resolving these issues, there are still concerns surrounding the transparency of the LTC regime and the subsequent tax outcomes that may result. Accordingly, taxpayers that use the LTC regime may have difficulty in

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76 Vial (n 12).

77 Freudenberg et al (n 23).

78 Smith (n 1).

79 Ibid.

80 Andrew Maples and Stewart Karlinsky, 'The United States Capital Gains Tax Regime and the Proposed New Zealand CGT: Through Adam Smith's Lens' (2014) 16(2) *Journal of Australian Taxation* 156.

81 Smith (n 1).

ascertaining their tax liability. For the same reason, the LTC regime is also problematic in respect to convenience; taxes are not easily assessed, and unpredictable tax outcomes may result in the associated tax impost arising at an inconvenient time for the taxpayer. Finally, given the complexity associated with the LTC regime, there also concerns around economy. Taxpayers that utilise the LTC regime will normally require assistance from a tax practitioner, leading to increased compliance costs. This is especially pertinent given that the target audience of the LTC regime is closely held companies, which are generally small, family businesses.

C *Government Tax Working Group*

The Government Tax Working Group also considered the taxation of closely held companies.[82] Whilst it was concluded that progressive taxation would be desirable, this was thought as being already possible through the LTC regime. Further, it was thought that the introduction of progressive taxation for closely held companies would result in higher compliance costs.[83] Overall, it is unclear whether the Government Tax Working Group viewed the LTC regime as being successful or not. However, given that one of the main recommendations was the implementation of a capital gains tax, it may have been that their focus was elsewhere.

Considering the findings above, and especially due to the compliance costs imposed by the LTC regime, an alternative basis of taxation may better deliver the objective of reducing compliance costs. In this regard, the Government Tax Working Group may have missed an opportunity. An example of an alternative basis of taxation is a full integration approach, which avoids the complexity associated with hybrid entities. On the other hand, a cash basis or concessionary accounting method may also result in reduced compliance costs for closely held companies.

VI CONCLUSIONS, LIMITATIONS AND FUTURE RESEARCH

Practitioners indicated that whilst small family businesses used the LTC regime, there were also other uses such as rental properties, companies anticipating losses and international tax structuring and planning. Practitioners indicated that it was they who recommended clients use the LTC regime, and that clients had very low levels of understanding surrounding the LTC

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[82] See, eg, Tax Working Group, *Future of Tax: Interim Report* (Report, 20 September 2018).

[83] Tax Working Group, *Future of Tax: Final Report Volume I: Recommendations* (Final Report, 21 February 2019).

regime. Regarding advantages, these were perceived to include fiscal transparency, limited liability, minimising double taxation in an international context, distributing tax-free capital gains and minimising tax on historic retained earnings. Disadvantages were considered to include the loss/deduction limitation rule, eligibility criteria, transparency issues, inability to quarantine profits or losses and ambiguous legislation. Notably, practitioners viewed the LTC regime as being complex and giving rise to increased compliance costs for those that use them. Part of this complexity arose from the now repealed loss/deduction limitation rule, however, other drivers of complexity still exist.

Whilst previous research has concluded that the LTC regime has been a success in respect to mitigating neutrality concerns,[84] this does not hold true from a compliance cost perspective. Accordingly, the LTC regime did not, and is still not, meeting one of its key objectives. That is, to minimise compliance costs for those that use them. This is contrary to Adam Smith's canons of certainty, convenience and economy. To this end, further overhauls are recommended. For example, further work could be done establish exactly how transparent LTCs are (or should be). As noted above, there is inherent complexity (and compliance costs) associated with hybrid entities. Thus, an alternative basis of taxation for closely held companies may better the objective of reducing compliance costs. International comparisons may provide useful insights and suggestions for this alternative basis of taxation.

Accordingly, the contributions of this research are two-fold. Firstly, this research provides an evaluation of the LTC regime from the perspective of tax practitioners. Secondly, this research concludes as to whether the LTC regime is meeting its objectives in respect of compliance costs, and how this might be improved upon.

This research is subject to several limitations. The first limitation is the lack of input from other stakeholders. Interviews with Inland Revenue or other parties involved in the policymaking process would provide useful insights into the LTC regime and better assist in evaluating its success. A second limitation of this research is its scope. Interviews were conducted in the course of fulfilling a Master of Commerce degree. As a consequence of this, there was a limited timeframe that the research was able to be completed within. In addition, there was a limit on the length of the research. This may mean that information has been missed, or not considered at all. Triangulation has been used to minimise this limitation, that is, documentary evidence

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[84] Sharma et al (n 22).

has been considered alongside interviews. Follow-up interviews with tax practitioners may have provided further insights into the complexity costs after the most recent round of amendments to the LTC regime, such as the removal of the loss/deduction limitation rule.