

November 2009**Inside this issue:**US S-Corporation & LLC
Interests – Beware the NZ Tax
ImplicationsGST Discussion Document
Issued**Directors:**

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US S-Corporation and LLC Interests – Beware the NZ Tax Implications

If your clients hold an interest in a US S-Corporation or US LLC or other “fiscally transparent” entity, then please read on as there may be NZ tax implications of which you are unaware.

S-Corporations are corporations that elect to pass corporate income, losses, deductions and credits through to their shareholders for US federal tax purposes. Shareholders of S-Corporations report the flow-through of income and losses in their personal tax returns and are assessed tax at their individual income tax rates. This avoids double taxation in the US as the US does not operate an imputation system.

A Limited Liability Company (LLC) is a business structure allowed by US State Statute. LLC’s are popular because owners have limited personal liability for the debts and actions of the LLC. An LLC can be classified as a corporation, partnership or sole proprietorship for US federal tax purposes. Where the LLC is treated as a partnership, the individual members return their share of income/losses for US tax purposes as above.

Entities such as LLC’s and S-Corporations are fiscally transparent because of their look-through or flow-through nature. This means that the individual members that hold interests in the S-Corporations or LLC’s are treated like partners in a partnership even though these entities have a separate legal identity.

Where a NZ tax resident holds such interests, the question then arises as to how these interests will be taxed in NZ (ignoring the transitional resident rules). Do we treat these holdings as an interest in a foreign company or do we simply tax the individual member? If we treat the holding as an interest in a foreign company then it is necessary to consider the CFC and FIF rules. In addition, what exactly is taxable in NZ, do we tax the income on which the individual has paid tax, even though this is retained by the LLC or S-Corporation? Or do we tax the distributions they have physically received? Is a credit available for the tax paid by the individual on income actually derived by the US entity? What part if any does the NZ/US Double Tax Agreement play?

Unexpected tax problems can arise where an entity is treated as fiscally transparent in the US but not in NZ. Where a NZ tax resident holds an interest in a US entity which is fiscally transparent for US tax purposes, it may be tempting to mirror the US treatment and return the income/loss in the NZ income tax return. This would however clearly be wrong! As NZ will not treat the entity as fiscally transparent, you need to consider whether the entity is treated as a NZ resident company, or is this an interest in a foreign company in which case will it be considered a CFC or a FIF interest. Recent changes to both regimes will impact on the treatment of the interest.

There were changes made to the tax laws effective from 1 April 2006 that go some way in alleviating tax consequences for such fiscally

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transparent entities. However, this is still a complex area of tax law and your clients will not thank you in the event that a wrong tax position is taken and penalties incurred!

If your clients hold such an interest and these questions cause you concern, we recommend that you seek advice from your nsaTax advisor.

Lisa Murphy**GST Discussion Document Issued**

The Government has released a new discussion document proposing legislative changes to the GST treatment of a number of transactions. The new document is a follow-on from the discussion document issued in June 2008 and the submissions that were made. Here is a brief summary of the new proposals.

Domestic Reverse Charge (DRC)

A DRC would apply to supplies between registered persons involving all land transactions, transactions valued at \$50 million or more, and going concerns.

The recipient of the supply (i.e. the purchaser) would account for the output tax on the sale (if any) and claim a deduction for the input tax on the purchase (where entitled) in the same GST period.

IRD note that the contract would need to be "GST exclusive" (as the recipient would not be paying the GST to the supplier) and set out the core information required so the parties are aware of their obligations. The document does not discuss how GST inclusive contracts will be dealt with.

The time of supply for transactions subject to the DRC would be when full payment is required (usually at settlement), not when just a deposit is paid.

Any later adjustments to the supply would be made by the recipient in the period in which they receive a debit or credit note.

The DRC would not apply to progressive supplies, sales in satisfaction of a debt, or deferred settlements that section 19D of the GST Act applies to.

Deferred Settlements – Section 19D of the GST Act

Currently a supplier on the payments basis who makes a supply valued at \$225,000 or more and with settlement deferred for more than a year must account for that supply on the invoice basis.

Under the proposal, instead of bringing forward the vendor's output tax liability, a recipient on the invoice basis will only be able to claim an input tax deduction on the payments basis.

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Sale in Satisfaction of Debt

Under a mortgagee sale, the mortgagee is required to pay the GST to the IRD. There are strict rules as to what constitutes a mortgagee sale. The proposal is to widen the scope of the section to apply also to what amount to defacto mortgagee sales. This would apply when a sale by the mortgagor is initiated, controlled or induced by the mortgagee. This could be indicated by such factors as the *mortgagee controlling the sale, signing the agreement or asking the mortgagor to sign, organising or paying for the services relating to the sale, using a common solicitor, or if the purchaser is associated with the mortgagee.*

Change in Use Adjustments

The current all or nothing approach to input tax claims with period by period change in use adjustments will be replaced with an apportionment method.

The initial input tax deduction will be based on the extent to which it is intended to use the item for making taxable supplies. For example a vehicle bought for 60% business and 40% private use would qualify for a 60% initial input tax credit.

Further adjustments would be required if the use changes by more than 5%, and would be made on an annual basis in the GST period closest to balance date.

A subsequent sale would be subject to full GST, with an additional deduction to the extent that the full input tax was not claimed.

Adjustments will not exceed the amount of GST the person would have been entitled to claim on acquisition, so the apportionment rules will not be able to be used to circumvent the limitations for a claim on a supply of secondhand goods between associated persons.

IRD want submissions on the above proposals by 16 December 2009. A copy of the Discussion document is available from IRD's website.

Gavin Stewart