

New Zealand's look-through company regime: A tax practitioners' perspective

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Abstract

This research explores look-through companies (LTCs) from the perspective of tax practitioners. Specifically, LTCs are compared with their predecessor, loss-attributing qualifying companies (LAQCs), in order to evaluate the efficacy of New Zealand's closely held company regimes. Whilst Parliament may have had the intention of reducing compliance costs with amendments and changes to closely held company legislation (such as introducing LTCs), empirical evidence suggests that the opposite has occurred. Interviews with tax practitioners were used to gather evidence and thus draw conclusions on the overall effectiveness of the LTC regime. As well as this, documentary analysis was used to understand the policy rationale in enacting closely held company legislation. Findings were interpreted using a branch of institutional theory, historical institutionalism.

The findings indicated that a range of businesses use the LTC regime. Practitioners did not have a consensus on what the typical use of LTCs may look like, but indicated that LTCs were used for rental properties, companies anticipating losses, small family businesses and for international tax structuring and planning. Whilst Inland Revenue and Parliament contemplated the use of the LTC regime for small family businesses in enacting the regime, the other uses were not expected. In fact, most of the other uses are directly in conflict with the rationale for the regime: eliminating the role tax played in choice of entity, achieving closer integration between the company and its shareholders, and reducing complexity.

Based on their experience, practitioners were generally of the view that the LTC regime resulted in higher compliance costs, especially when compared to QC/LAQCs. Additionally, practitioners were also of the view that the LTC regime resulted in higher compliance costs when compared to traditional structures such as sole traders, partnerships and companies. These higher compliance costs arise due to LTCs being more complex than these other structures. Practitioners stated that this complexity was due to two reasons: the loss/deduction limitation rule (and owners-basis test) and poorly drafted legislation.

As previously mentioned, reducing complexity was an original aim of special closely held company regimes. However, when considering these findings, it appears the opposite has occurred. This complexity was one of the reasons that practitioners did not generally

recommend the LTC regime to clients. However, if clients did use the LTC regime, it was almost always at the recommendation of practitioners. Clients tended to have very low levels of knowledge, and often knew more about LAQCs, which have been repealed for a number of years. Figures released under the Official Information Act indicated that LTCs have not been as popular as their predecessor, LAQCs. In the last year that LAQCs were in existence, there were 152,000 tax returns filed. This compares to 45,883 LTC returns being filed in 2016.

In regard to the rationale or motivation behind using LTCs, there was no consensus amongst practitioners. The most common reason for using the structure was the fiscal transparency that the structure provides. Some practitioners also viewed limited liability as being a reason for use. Other reasons for use included minimising double taxation, tax-free distributions to shareholders, and minimising tax on historic retained earnings. Another important reason for their use mentioned by practitioners was that LTCs were seen as a default replacement for LAQC/QCs and as such, many owners choose to transition into the LTC regime. However, this is also contrary to the policy rationale for the regime, reducing the role that taxation plays in the choice of entity structure.

Finally, practitioners were generally of the view that the most recent round of changes would decrease compliance costs for those that used the LTC regime. All practitioners were supportive of the removal of the loss/deduction rule, which, as previously mentioned, is a leading contributor to the regime's complexity. However, a number of practitioners believed that other changes should have been made to the regime. These included expanding the five counted-owners restriction, and clarifying the transparency of the LTC regime.

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Chapter 1: Introduction

1.1 Background

Both look-through companies (LTCs) and their predecessor, qualifying companies (QCs), have been subject to widespread criticism. The original intention of New Zealand's Parliament in establishing QCs was to simplify taxation for small, closely held companies by treating them the same, regardless of their legal structure (Consultative Committee on the Reform of the Taxation of Income from Capital, 1990; Inland Revenue Department, 1991). In practice, however, the QC regime and the associated legislation increased the compliance burden for small companies (Holmes, 1992; Ritchie, 2002; Freudenberg, 2004, 2005, 2008, 2009, 2011; Gupta, 2011). As well, the regime undermined tax neutrality by allowing excess tax losses to be deducted via a subset of QCs, the loss-attributing qualifying company (LAQC) which allowed losses to flow through to their shareholders, with little restriction. (Freudenberg, 2004, 2005, 2008, 2009; Inland Revenue Department, 2010) and thus provided arbitrage opportunities for taxpayers (Inland Revenue Department, 2010).

These issues with the QC/LAQC regime were seen as the catalyst for the implementation of the LTC regime. The QC/LAQC regime was repealed for the financial year beginning 1 April 2011, and replaced with the LTC regime (Inland Revenue Department, 2011c). Existing QCs were 'grandfathered' with transitional rules being put in place (Inland Revenue Department, 2014). Recent commentary suggests that there are still 70,000 QCs that are yet to transition to a different structure (Inland Revenue Department, 2016b). QCs are covered by amended QC rules, and can no longer gain special transitional tax treatment. These QCs are able to transition into other entities, including LTCs, but this could now be at a tax cost (Inland Revenue Department, 2011b). The LTC regime was aimed at improving tax neutrality and limiting arbitrage opportunities to taxpayers by implementing rules such as those that limited losses available to shareholders (the loss limitation rule).

However, despite Parliament's intentions, this new regime has also been subject to considerable criticism. The legislation enacting LTCs was rushed through Parliament, omitting key consultative processes such as the Generic Tax Policy Process, which

necessitates public scrutiny (Vial, 2012). This has resulted in the original legislation being amended numerous times since its inception (Sawyer, 2014). As well as this, it is debatable whether the regime has decreased the complexity of closely held company legislation, and thus the compliance costs for these companies (Jamieson, 2011; Freudenberg, Tran-Nam, Karlinsky, & Gupta, 2012; Inland Revenue Department, 2015a). It is hardly surprising that now, after only five years, major changes have been made to the LTC regime. One of the major changes was the removal (or simplification) of the loss limitation rule, which is often cited as a leading contributor to legislative complexity. At the time of writing, 14 August 2017, the Bill containing the latest round of amendments to the LTC regime had just been enacted. Most changes take effect from the start of the 2017/18 tax year.

Thus, this research seeks to establish whether the LTC regime has achieved its objectives, especially regarding reducing compliance costs for closely held companies. Anecdotal evidence suggests that, in fact, the opposite has occurred: complicated legislation has increased compliance costs for these companies that are subject to the regime. Since LTCs must have five or fewer ‘look-through counted owners’ (Inland Revenue Department, 2014), this restricts the availability of the regime to small businesses. Most small businesses engage tax practitioners to assist with their tax obligations (Inland Revenue Department, 2016c), resulting in external compliance costs (Evans & Tran Nam, 2014). Thus, this research incorporates interviews with tax practitioners, who often deal with the day-to-day tax compliance activities for small businesses. Tax practitioners provide a unique and insightful perspective on how the changes to closely held company legislation have impacted compliance costs. As well, tax practitioners and practitioner groups have provided feedback on the proposed changes to the LTC regime, possibly leading to better tax policy development.

1.2 Research Questions

The primary research questions this thesis addressed were as follows:

- RQ 1: What types of businesses typically use the LTC regime?
- RQ 2: Based on their experience dealing with clients, do tax practitioners believe that the LTC regime has reduced compliance costs compared with QC/LAQCs, as well as compared with other structures?
- RQ 3: To what extent do tax practitioners recommend the adoption of the LTC regime to clients?
- RQ 4: Overall, what is the primary reason (or motivation) for clients to utilise the LTC regime?
- RQ 5: Do tax practitioners believe the changes to the LTC regime will decrease compliance costs? Why or why not?

These research questions were aimed at evaluating the LTC regime from tax practitioners' perspectives. QCs, specifically LAQCs, were used as a basis for comparison, as well as other structures such as traditional companies and partnerships. These questions were also aimed at investigating the efficacy of the proposed changes to the LTC regime.

1.3 Importance of Topic

Like most countries, New Zealand's small business sector is a vital component of the economy. It is estimated that 97% of businesses in New Zealand are small businesses, totalling 459,300 altogether (Ministry of Business Innovation & Employment, 2014). Whilst from the perspective of company law, closely held companies are no different from other companies, they do differ from a tax law perspective. Generally, closely held company structures are only available to small businesses due to restrictions on the number of owners. QCs/LAQCs have seen widespread use in New Zealand since their inception. It was estimated that there were over 130,000 active LAQCs in existence at the time of the LTC regime implementation (Nash, 2010). These 130,000 companies accounted for approximately \$2.3 billion of tax losses in their ultimate year of operation (Cunliffe, 2010). However, an Official Information Act request by the author revealed that both the number of LAQCs, as well as the number of tax losses, was actually greater than this. Table 5.1 provides a full breakdown of the number of closely held companies (LTCs, QCs, and LAQCs) in New Zealand, along with their losses for each tax year. These figures indicate the wide reach of the LTC regime, meaning that research into this topic is relevant to numerous parties. Since public consultation was not invited before the LTC regime implementation (for only the second time since inception, the Generic Tax Policy Process was not followed) (Vial, 2012; Sawyer, 2013b), research into the regime's effectiveness, now five years on, is long overdue.

Furthermore, small businesses typically have disproportionate tax compliance costs (Sandford & Hasseldine, 1992). This means that any legislative changes should be aimed at reducing legislative complexity, and thus compliance costs. The LTC regime has been subject to numerous amendments since it was first implemented (Sawyer, 2014), which has caused confusion amongst both businesses and tax practitioners. The amendments have meant the regime's complexity has increased, which has consequently impacted on compliance costs. Because of this, certainty has decreased, which is significant considering New Zealand's self-assessment tax system (Jamieson, 2011). As a result, any research into the efficacy of the LTC regime is especially helpful to tax policy-makers regarding tax compliance efforts.

The research is also especially topical due to the recent changes to the LTC regime. The Regulatory Impact Statement (Inland Revenue Department, 2015b) has grouped issues with LTCs into three main groups. These are as follows:

1. Rules which impose unnecessary compliance costs
2. Rules which restrict commercial practice
3. Rules which fail to achieve their intended policy objectives

Whether the proposed changes to LTCs will solve these issues is yet to be seen, but interviews with tax practitioners help answer this, increasing the value of this research. Interestingly, the Regulatory Impact Statement mentions that some options may increase compliance costs, so interviews will be used in gauging whether this could be the case. The Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill (Inland Revenue Department, 2016b) was introduced to Parliament in May 2016, and received Royal Assent in March 2017, with most changes being enacted from the start of the 2017/18 tax year.

1.4 Structure of Thesis

The remainder of this thesis is arranged in the following manner. Chapter 2 reviews prior research on closely held companies, tax compliance, tax complexity and tax practitioners. Chapter 3 sets out the research questions, methods and approach utilised in this thesis. Chapter 4 presents the information collected from the interviews with tax professionals. Chapter 5 analyses the findings of these interviews, followed by Chapter 6, which provides an overall discussion of the major findings and sets out a conclusion for this thesis, along with limitations and areas of future research.

1.5 Contribution to Knowledge

This research contributes to the limited knowledge of New Zealand's LTC regime. Specifically, the results of interviews with tax practitioners may help policy-makers evaluate whether the LTC regime is meeting its original objectives, as intended by Parliament. This will help with future policy development. As well, little research on closely held companies has been undertaken in New Zealand from tax practitioners' perspectives. This research expands on this and adds to this body of knowledge. To the author's knowledge, this is the first piece of empirical research conducted on New Zealand's LTCs.

Chapter 2: Literature Review

2.1 Introduction

Qualifying companies (QCs), as well as the subset, LAQCs, were introduced after recommendations from Consultative Committee on the Reform of the Taxation of Income from Capital (1990). QCs were 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 and minimised complexity. The QC regime was superseded by the LTC regime from the financial year beginning 1 April 2011. The LTC regime is unique from a company law perspective in that it can only have five or fewer look-through counted owners. Traditionally, only one class of share was allowed, but this has now changed. Other features are shared with alternative structures such as:

- Limited liability.
- Profits are taxed at the level of the shareholders' marginal tax rate.
- Losses are available to shareholders subject to loss limitation rules.
- Capital gains are never taxed.
- Shareholders are taxed on their share of revenue account gains/losses and depreciation adjustments subject to de minimis rules.

Table 2.1 outlines where LTCs, and their predecessor, the QC/LAQCs, fit into New Zealand's business structure environment. Both LAQCs and LTCs are examples of a hybrid entity, essentially combining features of a partnership with features of a company (Freudenberg, 2011). Whilst LTCs share some features with the traditional company structure, they also have some important differences, as outlined by Table 2.2.

Table 2.1: Business Structures Available to Taxpayers in New Zealand

	Direct ownership	General partnership	Limited partnership	LTC	LAQC	QC	Trust	Company
Ownership rules	N/A	No restrictions	No upper limit on number of partners but must have at least one general partner, and one limited partner	Five or fewer look-through owners	Was five or fewer shareholders including associates	No new QCs allowed. Existing QCs must have five or fewer shareholders including associates	No restrictions on settlors or beneficiaries	No restrictions
Different ownership rules / class of shares	N/A	Partnership agreement could provide for different rights for different partners	Partnership agreement could provide for different rights for different partners	Only one class of share allowed	Multiple classes of shares allowed	Multiple classes of shares allowed	Trust agreement could provide for different rights for different beneficiaries	Multiple classes of shares allowed
Owner's liability	Unlimited	Unlimited	Limited	Limited	Limited	Limited	Limited for beneficiaries, unlimited for trustees	Limited
Tax rate	Owner's tax rate	Partners' tax rates	Partners' tax rates	Shareholders' tax rates	Company tax rate on accrual, adjusted to shareholders' tax rates on distribution	Company tax rate on accrual, adjusted to shareholders' tax rates on distribution	Trustee income taxed at equivalent to top personal rate, beneficiary income taxed at beneficiaries' tax rates	Company tax rate on accrual, adjusted to shareholders' tax rates on distribution
Losses	Available to owner	Available to partners	Available to partners subject to loss limitation rules	Available to shareholders subject to loss limitation rules	Available to shareholders	Quarantined to company	Quarantined to trust	Quarantined to company
Capital gains	Never taxed	Never taxed	Never taxed	Never taxed	Never taxed	Never taxed	Never taxed	Not taxed on accrual, may be taxed on distribution
Ownership changes / restructures	Owner taxed on revenue account gains / losses and depreciation adjustments	Partners taxed on share of revenue account gains/losses and depreciation adjustments subject to de minimis rules	Partners taxed on share of revenue account gains/losses and depreciation adjustments subject to de minimis rules	Shareholders taxed on share of revenue account gains/losses and depreciation adjustments subject to de minimis rules	Not taxed (unless shareholder holds shares on revenue account)	Not taxed (unless shareholder holds shares on revenue account)	Not taxed (beneficiaries' rights could be changed by varying trust agreement)	Not taxed (unless shares are held on revenue account) Shareholder continuity requirements apply – if breached, losses and imputation credits are forfeited

Source: Inland Revenue (2015, p. 8)

Table 2.2: Differences Between LTCs and Traditional Companies

	LTC	Company
Requirements		
Shareholding	Shareholders in an LTC must be either natural persons or trustees. An ordinary company can't hold shares in an LTC. Another LTC can hold shares in an LTC. An LTC must only have one class of shares carrying the same voting rights	None
Foreign Company	Can't be an LTC.	Can be a New Zealand resident company
Distributions		
Dividends	Not taxable, as income of LTC will be "looked-through" to establish owner's income.	Taxable
Shareholder-employee salaries	Owners of a look-through interest in an LTC can't receive shareholder-employee salaries. Instead, payments to a working owner are included in the owner's salary or wages and the PAYE rules apply. Payments to working owners are deductible to all owners of an LTC, in proportion to their effective look-through interest.	Deductible to the company and assessable to the shareholder employees. May not be subject to PAYE rules.
Imputation credits received	Passed through to look-through owners.	Credit to imputation credit account (ICA) and offset against tax liability
Share sales or repurchases	Look-through owners treated as disposing of, or acquiring, the underlying LTC property and need to account for tax on the disposal (subject to certain thresholds)	General rules apply
Income, losses and expenditure		
Income	Passed on to look-through owners in proportion to their effective look-through interest in the LTC.	General rules apply
Expenditure and losses	Passed on to look-through owners in proportion to their effective look-through interest in the LTC. A loss limitation rule applies to losses from an LTC.	General rules apply
Loss offsets and subvention payments	LTCs can't group with other companies to receive a loss offset or make a subvention payment.	General rules apply
Imputation		
Imputation credit account (ICA)	LTCs don't keep an ICA.	Keeps an ICA unless excluded

Source: Inland Revenue (2014 p. 5)

2.2 Legislative History

As mentioned previously, QCs were introduced at the recommendation of Consultative Committee on the Reform of the Taxation of Income from Capital (1990), who were tasked with reviewing New Zealand's income tax system in the 1980s and 1990s. 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 (Inland Revenue Department, 1991). 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 (Income Tax Amendment Act (No 2), 1992). Companies electing to become a QC were subject to qualifying company election tax on entry (QCET), 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 (ICA), effectively changing QCET into a withholding tax (Inland Revenue Department, 2008).

A subset of QCs, the LAQC, was initially rejected by the Valabh Committee due to fears that different classes of shares would make attributions complicated and impractical (Consultative Committee on the Reform of the Taxation of Income from Capital, 1990). However, a raft of submissions from interest groups forced policy-makers to reconsider, and LAQCs were permitted provided that there was only one class of shares available (Hale & Johnston, 2011). 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. Consultative Committee on the Reform of the Taxation of Income from Capital (1990) 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. Whilst there was a provision in the legislation aimed at limiting the amount of tax losses shareholders could access, this was largely considered ineffective (Plunket & Wells, 2008).

Both QCs and LAQCs were subject to few legislative amendments during their existence (Hale & Johnston, 2011); however, LAQCs were a common component in many tax avoidance arrangements (Inland Revenue Department, 2007). Examples include *Case Z20*

[2009] 24 NZTC 14,271, 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 guilty of tax avoidance (Quintal & MacLaren, 2010). A further example can be found in *Ben Nevis Forestry Ventures Limited and Ors v the Commissioner of Inland Revenue* [2008] 24 NZTC 23,188, where taxpayers utilised LAQCs 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 (Inland Revenue Department, 2010). 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) rules. It has been contended that LAQCs could have been used to structure around loss limitation rules in LPs, as LAQCs could be general partners in a LP (Inland Revenue Department, 2006). An interesting point is that while the Tax Working Group (TWG) 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 Government (Tax Working Group, 2010).

Instead, the QC and LAQC regimes were replaced by the LTC regime. The main features of this regime are summarised in Tables 2.1 and 2.2. The LTC regime, contained in subpart HB of the Income Tax Act 2007,¹ 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 via a Supplementary Order Paper. This meant that key tax policy processes (such as the Generic Tax Policy Process which necessitates public scrutiny) were omitted (Vial, 2012; Sawyer, 2013b). 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

¹ Unless stated otherwise, all legislative references are to the Income Tax Act 2007.

(nsaTax, 2011; KPMG, 2012; New Zealand Law Society, 2012). Table 2.3 outlines a timeline of the LAQC/QC tax reform process.

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 introduced a raft of amendments, covering things such as QC amalgamations, tax elections, valuation and timing methods and the look-through counted owner test. Now, further major overhauls to the LTC regime have just enacted with the Taxation (Annual Rates for 2016–17, Closely Held Companies, and Remedial Matters) Bill. The main changes were the removal (or simplification) of the loss limitation rule and changes to entry criteria. As well as these, there were a range of measures aimed at decreasing compliance costs for taxpayers that use LTCs. The Bill was enacted on 30 March 2017, with most changes taking effect from 1 April 2017.

Table 2.3: Timeline of LTC/QC Reforms

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.
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.

Source: Adapted from Vial (2012 p. 328).

2.2.1 Recent Developments

As mentioned previously, the law reform process for the look-through company regime has recently occurred. This reform was intended to increase the ‘workability’ of the regime and more closely align the regime with the intended policy objectives (Finance and Expenditure Committee, 2016a). At the time of writing, the Bill had recently been enacted, following debate in Parliament and having passed through the Select Committee phase. The Select Committee phase necessitates public scrutiny by requesting submissions on the Bill from the public. While 38 submissions were received, some of these submissions were solely concerned with other changes contained in the omnibus bill. Of the submissions relating to the changes to LTCs, the majority supported the proposed reduction in scope of the loss limitation rule (Chartered Accountants Australia and New Zealand, 2016; KPMG, 2016; New Zealand Law Society, 2016; Offen Advisors, 2016; PricewaterhouseCoopers, 2016; Whyte Group, 2016). As consequence of the legislative amendment, the loss limitation rule now only applies to LTCs in a partnership or a joint venture, which is considered to be an insignificant number. Support for this change was due to the belief that the simplification of the loss limitation rule would greatly decrease the complexity, and thus the compliance costs associated with use of the regime. Additionally, the majority of submissions were supportive of changes to the tainted capital gains rule² (Chartered Accountants Australia and New Zealand, 2016; KPMG, 2016; New Zealand Law Society, 2016; PricewaterhouseCoopers, 2016).

However, a number of submissions also indicated that the (then) proposed changes did not deal with the underlying complexity of the regime. For example, one submission stated that LTC election and eligibility was a problematic area, and efforts should be concentrated on simplifying this (PricewaterhouseCoopers, 2016). In fact, other submissions viewed these changes in the Bill in these areas as increasing the complexity of the regime (Chartered Accountants Australia and New Zealand, 2016; New Zealand Law Society, 2016). Furthermore, it was also contended that the proposed changes may lead to increased ambiguity, unless these were amended prior to enactment (New Zealand Law Society, 2016). Another submission highlighted that whilst LTCs are intended to be transparent for taxation

² Under the previous rules, restructuring of LTCs and liquidations often led to capital gains, which were taxable under s CD 44. These rules were thought to have led to a large number of insurance claims by tax practitioners unaware of the consequences of restructuring or winding up LTCs (Turner, 2016).

purposes, there was still vagueness surrounding exactly how transparent they were (Chartered Accountants Australia and New Zealand, 2016). Table 2.4 summarises the proposed changes, and Table 2.5 summarises the relevant submissions and official responses.

Table 2.4: Summary of Proposed LTC Rule Changes

Proposal	Current Rules	Proposed Rules
Tightening the eligibility criteria for look-through companies (LTCs)	<ul style="list-style-type: none"> Only those beneficiaries that receive beneficiary income sourced from a look-through interest. Trusts that own LTCs are free to make distributions to corporates without consequence. Charities and Māori authorities are able to be LTC owners. There is no restriction on LTCs earning foreign income. 	<ul style="list-style-type: none"> Any beneficiary who receives any distribution from a trust with a look-through interest will be counted as an owner. If a trust that owns an LTC makes a distribution to a corporate shareholder, LTC status is lost. Charities and Māori authorities are precluded as being LTC owners. Foreign controlled LTCs are unable to earn foreign income of \$10,000 or 20% of the LTCs gross income.
Modifying the entry tax calculation for LTCs so it is calculated at each shareholder's personal tax rate	<ul style="list-style-type: none"> LTC entry tax is calculated at the company tax rate, which is 28%. 	<ul style="list-style-type: none"> To reduce under or over taxation LTC entry tax is to be calculated at each shareholder's personal tax rate.
Restricting the coverage of the deduction limitation rule	<ul style="list-style-type: none"> Losses flow to the shareholders of LTCs subject to the deduction limitation rule, which allocates losses to the extent of the shareholders interest of basis in the LTC. 	<ul style="list-style-type: none"> The deduction limitation rule will only apply to LTCs in partnership or joint venture.
Addressing concerns about how the debt remission rules work in relation to LTCs and partnerships	<ul style="list-style-type: none"> Debt remission income will arise to a LTC owner who undertakes self-remission. 	<ul style="list-style-type: none"> Debt remission income will not arise to a LTC owner who undertakes self-remission. The debt owed by a LTC to third parties must be adjusted for any credit impairment

Removing qualifying status for qualifying companies (QCs) that have a change in control of the company	<ul style="list-style-type: none"> Qualifying companies are not subject to continuity tests in order to retain QC status. 	<ul style="list-style-type: none"> To retain QC status, there must be at least 50% continuity in the shareholding of the company.
Narrow the scope of the “tainted capital gains” rule	<ul style="list-style-type: none"> Some capital gains made by a company are taxable when distributed on liquidation of the company. 	<ul style="list-style-type: none"> These capital gains will only be taxable if there is at least 85% common shareholding interests between the buying and selling companies.
Addressing current over-taxation of certain dividends under the resident withholding tax (RWT) rules	<ul style="list-style-type: none"> Companies must deduct RWT from a fully imputed dividend paid to corporate shareholders. 	<ul style="list-style-type: none"> Companies will be able to opt out of deducting RWT from a fully imputed dividend paid to corporate shareholders. There will be a new formula that is used when calculating RWT when cash and non-cash dividends are paid simultaneously.
Enabling shareholders receiving shareholder salaries to elect to split their income so their base salary is subject to PAYE and the variable amount is paid out before tax	<ul style="list-style-type: none"> Shareholders that are employees of close companies and who receive regular wages must withhold tax from bonus salary. 	<ul style="list-style-type: none"> Shareholders that are employees of close companies and who receive regular wages can choose to not to withhold tax from bonus salary.

Sources: Finance and Expenditure Committee (2016b); Inland Revenue Department (2016b)

Table 2.5: Summary of Main Submissions and Responses

Main Submission (s)	Submitter	Officials Response
<ul style="list-style-type: none"> A section should be introduced into the legislation, which means that section CW 14 applies unless the company has an overdrawn current account. 	Alexandra Low & Associates	<ul style="list-style-type: none"> This should apply if the QC has paid unimputed dividends before or it has been less than seven years since the company became a QC.
<ul style="list-style-type: none"> Legislation around election (s HB 13) has ‘problematic language’ and does not provide enough clarity to the taxpayer. 	Chapman Tripp	<ul style="list-style-type: none"> Numerous technical and drafting amendments are being made, however this specific point has been noted.
<ul style="list-style-type: none"> Support for the reduction in scope of the loss limitation rule. The eligibility criteria for LTCs is too complex, and the proposed changes exacerbate this. Work needs to be done to establish exactly how transparent LTCs are. Grandparenting needs to occur so that existing LTCs are not adversely impacted by the proposed changes. Shareholding changes in existing QCs should not be subject to the proposed continuity test. Support for the removal of the tainted capital gains rule. Broader contextual issues such as a capital gains tax should be addressed. 	Chartered Accountants Australia and New Zealand	<ul style="list-style-type: none"> The proposed changes to eligibility criteria for LTCs will not impact on the majority of LTCs. The criteria are required to ensure LTCs meet their policy objectives. LTC transparency is an area that needs work in the future. Proposed changes should be grandparented so that existing LTCs are unfairly penalised. Shareholding changes in existing QCs should be subject to a continuity test, unless the shareholding change is between close relatives.
<ul style="list-style-type: none"> LTC eligibility rules should be broadened to allow companies to shareholders of LTCs. Support for the removal of the tainted capital gains rule, but it should be clarified further. 	Corporate Taxpayers Group	<ul style="list-style-type: none"> It is argued that allowing companies to be shareholders of LTCs could provide unfair tax advantages.

<ul style="list-style-type: none"> • In general, support for the proposed changes. • Clarification is required around whether look-through counted owners include interposed trusts. 	Deloitte	<ul style="list-style-type: none"> • A Tax Information Bulletin will clarify the new look-counted owner test.
<ul style="list-style-type: none"> • In general, support for the proposed changes. • Shares in LTC should be able to have disproportionate voting rights. • Some terms and definitions should be clarified or expanded on. 	Ernst & Young	<ul style="list-style-type: none"> • Shares should have disproportionate voting rights if they have proportionate rights. • Numerous technical and drafting amendments are being made.
<ul style="list-style-type: none"> • Charities and Māori authorities should not be precluded from being LTC shareholders. 	Hugh Green Foundation	<ul style="list-style-type: none"> • It is recommended that charities and Māori authorities who are shareholders should be subject to grandparenting to minimise compliance costs, but, should not be able to be shareholders.
<ul style="list-style-type: none"> • In general, support for the proposed changes. • The proposed tightening of the counted owners test is too onerous. • The proposed continuity test for QCs is unnecessary. • Some terms and definitions should be clarified or expanded on. 	KPMG	<ul style="list-style-type: none"> • The proposed changes to eligibility criteria for LTCs will not impact on the majority of LTCs. The criteria are required to ensure LTCs meet their policy objectives. • Shareholding changes in existing QCs should be subject to a continuity test, unless the shareholding change is between close relatives. • Numerous technical and drafting amendments are being made.
<ul style="list-style-type: none"> • The LTC eligibility rules should not be tightened. If they are there may be increased compliance and tax costs. • The proposed change to the loss limitation rule is supported. • Consideration should be given to repealing the QC regime. • The proposed relaxing of the tainted capital gains rule is supported. 	New Zealand Law Society	<ul style="list-style-type: none"> • The proposed changes to eligibility criteria for LTCs will not impact on the majority of LTCs. The criteria are required to ensure LTCs meet their policy objectives. • Shareholding changes in existing QCs should be subject to a continuity test, unless the shareholding change is between close relatives.

<ul style="list-style-type: none"> Some proposed changes should not apply retrospectively, due to the circumstances not warranting this. 	Offen Advisors	<ul style="list-style-type: none"> Retrospective changes are considered necessary so that LTC rules work as intended.
<ul style="list-style-type: none"> The use of the GTPP is commended. Restriction on LTCs to receive foreign-sourced income should be relaxed. 	Olivershaw	<ul style="list-style-type: none"> Only a small amount of LTCs receive foreign income, this change is part of an overall tightening of foreign trust disclosure rules.
<ul style="list-style-type: none"> LTC eligibility criteria should not be tightened. Charities should be able to be LTC shareholders. The proposed changes should be grandfathered so that existing LTCs aren't penalised. The proposed changes do not address the underlying complexity of LTCs. The proposed changes to the loss limitation and tainted capital gains rules are supported. 	Pricewaterhouse Coopers	<ul style="list-style-type: none"> Whilst charities should not be able to be LTC shareholders, there should be transitional rules for existing charities that are LTC shareholders. Other proposed changes should be grandfathered so that existing LTCs are not unfairly penalised.
<ul style="list-style-type: none"> LTC income should not all be taxed at marginal or trustee rates. Trusts should be able to be LTC shareholders, regardless of number of beneficiaries. Entry tax should remain as is. The overall tightening of LTC rules will increase compliance costs. 	The Whyte Group	<ul style="list-style-type: none"> The proposed changes to eligibility criteria for LTCs will not impact on the majority of LTCs. The criteria are required to ensure LTCs meet their policy objectives. Changes to entry tax are required to ensure retained earnings are appropriately attributed to shareholders at their personal tax rates.

Sources: Finance and Expenditure Committee (2016b); Inland Revenue Department (2016b)

2.3 Academic Literature on Closely Held Companies

2.3.1 Overview

There are relatively few academic studies on both QC/LAQCs and LTCs. Those that exist primarily take a tax policy or theoretical approach, rather than utilising empirical data (Holmes, 1992; Freudenberg, 2004, 2005, 2008, 2009, 2011; Jamieson, 2011; Vial, 2012). However, there have been two studies (Ritchie, 2002; Gupta, 2011) involving LAQCs that have utilised empirical data. Although LAQCs were not the main focus of each study, the findings indicate that LAQCs resulted in increased tax compliance costs for those that used them. As far as the researcher is aware, there have been no empirical studies to date that focus on LTCs.

2.3.2 Qualifying Companies

An empirical study conducted by Ritchie (2002) involved examining the compliance costs of five different entities in New Zealand, one of which was a LAQC. The owner of the LAQC believed that they would have lower than average compliance costs, compared to the other entities in the study. On the contrary, it was found that the LAQC owner actually had significantly greater compliance costs. However, these results should be interpreted with caution due to the small sample size. As well as this, the LAQC owner was a tax practitioner. This may have meant that the LAQC incurred greater compliance costs due to more thorough regulatory compliance required to satisfy the tax practitioner's professional standards.

A later study by Gupta (2011) also surveyed tax practitioners in New Zealand, with a focus on the complexity in New Zealand's tax system. Questionnaires were issued on aspects of the tax system, and the information from this was used to rank different aspects of the tax system in order from the most complex to the least complex. QCs and LAQCs were ranked 12th out of 35 different aspects. Comparatively, the dividend imputation scheme was ranked 17th, resident trusts were ranked 20th, and company tax rates were ranked 26th. This therefore suggests that QCs and LAQCs are more complex than other business structures. Interestingly, LP taxation was ranked at 11th, which may indicate that this structure is more complex than QCs and LAQCs. However, this could be attributed to the then recent enactment of the Limited Partnership Act 2008 that enabled LPs to be used.

Holmes (1992) evaluated the New Zealand Income Tax Amendment Act (No.2) 1992, which introduced the QC regime, and concluded that, in fact, small businesses that had adopted the regime faced more complex legislative requirements. This manifested in significant monetary and administrative downtime costs. It was thus suggested that a full integration system could overcome this complexity. Numerous other studies have also pointed to LAQCs' increasing legislative complexity and thus compliance costs, albeit from a theoretical or policy perspective (Freudenberg, 2004, 2005, 2008, 2011). Freudenberg (2009) recognised that whilst the LAQC regime did increase compliance costs, New Zealand's rules for QCs imposed the least tax compliance costs in comparison to other jurisdictions with their own versions of flow-through entities.

It has also been suggested that the QC regime undermines tax neutrality. Freudenberg (2004) looked at QCs as a potential candidate for adoption by Australia but argued that neutrality would be compromised with such a regime. Various scenarios where LAQCs are used in tax avoidance arrangements highlight this. These include examples such as taxpayers selling private homes to LAQCs, film investment schemes and forestry schemes. Freudenberg (2005) came to a similar conclusion, but this is due to a comparison drawn between the original objectives of LAQCs and what actually resulted. The original objective of the QC regime was to tax entities that operated in similar businesses similarly, regardless of tax structure. Freudenberg (2004) contended that this had not transpired, and there were substantial inconsistencies between LAQCs and other tax structures such as partnerships.

Comparison between the United States' S corporation (a flow through entity where profits/losses are passed onto its shareholders) and LAQCs has also been made (Freudenberg, 2008). One of the main differences illustrated is the lack of an initial restriction on shareholders utilising allocated losses. In the United States, this is done on the basis of measurement of the shareholder's equity investment in the entity (often referred to as membership cost basis). As mentioned previously, New Zealand's LAQC regime did have a provision aimed at limiting the losses shareholders could access, but this was largely ineffective. It was thus concluded that tax transparent structures such as LAQCs can cause tax revenue leakage, especially if members are able to deduct losses in excess of their financial exposure. A later piece of work by Freudenberg (2009) builds on this, concluding

that the United States' S corporation better limits losses to a member's financial exposure amount, via basis restriction rules.

2.3.3 Look-through Companies

Jamieson (2011) concludes that the new LTC legislation is difficult and obtuse. It is stated that the only way that New Zealand Institute of Chartered Accountants (NZICA, now Chartered Accountants Australia and New Zealand (CAANZ)) have been able to gain confidence in intended outcomes is via policy discussions with officials, which is contradictory to New Zealand's self-assessment system. Overall, the drafting of the LTC regime legislation is considered to be poor, and the Tax Information Bulletin (Inland Revenue Department, 2011c) which was issued at the time of enactment to clarify the LTC legislation, does not deal with a number of issues.

Vial (2012) looks at the implementation of LTCs, and the process by which these policy changes were developed and enacted. He notes that the usual framework for tax policy implementation, the GTPP, was not adhered to. This process essentially provides a more rigorous process for legislation by necessitating public scrutiny. The absence of this process means that arguably political expediency prevailed in this instance. Sawyer (2013b, p. 420) expands on this, stating that "since the LTC regime was enacted, major amendments are in the process of being made to the regime, and practitioners have been critical of many aspects of the regime".

Furthermore, Freudenberg et al. (2012) conclude that in general, tax flow-through entities, such as QCs and LTCs, lead to a greater compliance burden for small businesses. Thus, simplification of rules will still lead to a greater overall compliance burden in comparison with other business structures, such as traditional companies. This sentiment is shared by the Office of Tax Simplification (OTS) in the United Kingdom (UK), which concluded that look-through taxation results in greater complexity in comparison with a traditional company structure (Office of Tax Simplification, 2016).

2.3.4 Summary

There has been little empirical research on QCs and none on LTCs, especially from a tax practitioner's perspective. Most studies have been theoretical and policy focused in nature, apart from two studies that could be classified as empirical. However, in these two studies the focus was not primarily on QCs or LTCs. Most theoretical and policy studies conclude that LAQCs caused issues with both tax neutrality and compliance costs. Furthermore, LTCs are seen as having similar issues, which are exacerbated by a truncated policy development process.

2.4 Limited Partnerships

As mentioned previously, another factor in the repeal of the LAQC/QC regime was the introduction of the Limited Partnership (LP) Act 2008. It was thought the LAQCs could be used as a general partner in an LP, resulting in excessive tax benefits. However, Parliament's intention in introducing the LP regime was to encourage foreign investment by removing tax and regulatory barriers. Additionally, the regime is aimed at harmonising New Zealand's tax structures with those available in other jurisdictions (Inland Revenue Department, 2006; Plunket & Wells, 2008). LPs share a number of similarities with LTCs, such as limited liability and the flow through of profits and losses.

LPs share many features with LAQCs and their successor, LTCs, the most notable being the fact that the structures are not taxed as a separate legal entity. Instead, they are fiscally transparent. This means that profits and losses flow through to the partners or shareholders without being taxed. In LPs, losses available to partners are limited by a loss limitation rule in section HG 11. The idea behind this is to deny a limited partner a deduction for expenditure, which is funded by debt for which the partner has no personal liability. Plunket and Wells (2008) note that this loss limitation provision is significantly tougher than the 'rather oddly' worded piece of legislation (s HA27), which was aimed at limiting the losses available to LAQC shareholders.

Another difference can be found in the intended uses for each regime. Whilst LAQCs/LTCs, are targeted towards closely held companies, limited partnerships are targeted at investors and venture capitalists. Regarding LAQCs, several features made the structure inappropriate

for investors. For example, shareholders were liable for any unpaid company tax, which reduced the appeal of the structure. There were also relatively strict compliance requirements to ensure that QC status was maintained, which again reduced the appeal of the structure. Additionally, one of the core characteristics of both LAQCs and LTCs, the limit on shareholders, means that the structure is unsuitable for investors (Borrie, 2007). Smith (2008) suggests that because the regimes were aimed at different circumstances, they should be mutually exclusive.

2.5 Tax Policy Process Literature

2.5.1 Introduction

The tax policy process is the mechanism by which changes to tax rules become legislation. Inevitably, this process is intertwined with politics: legislation needs to be enacted through a political and constitutional structure in order for tax to exist in the first instance (Sawyer, 2013b). In fact, previous literature has pointed to the ‘over-politicisation’ of the tax policy process (Hill, 2005). As well as political influence, there are also many other groups and actors which influence the policy making process, including lobby groups, officials, Government departments and the public (Sawyer, 2013b).

2.5.2 Tax Policy Process in New Zealand

Since the 1980s, the tax policy process in New Zealand has involved third parties such as taxation practitioners and the wider public. Previously, taxation reforms were motivated and introduced primarily by the Minister of Finance, often in defiance of advice from other Government agencies (Sawyer, 1996). This third party consultation increases the transparency and thus the efficacy of legislative changes, which was a key reason why major taxation reforms in the 1980s were successful (Sawyer, 2013a). Additionally, consultation helps overcome tension between different stakeholders affected by legislative changes, increasing confidence in Government.

The level of consultation has gradually increased since the 1980s, and in 1994 the Organisational Review Committee suggested the creation of the Generic Tax Policy Process (GTTPP). This is a refinement of consultative committees, and is aimed at providing a ‘clear strategic focus for tax policy and a structured way of engaging with taxpayers and tax

advisors (Sawyer, 1996). The GTPP has been widely acclaimed as a beneficial process, but interestingly, it is not a legislative requirement that taxation policy development uses this process. However, it has only been bypassed twice since its inception, one of these times being during the enactment of the LTC regime. It has been speculated that omitting this process has directly resulted in poor legislation being drafted (Vial, 2012).

The GTPP itself has five core stages, and within these stages are multiple phases. These stages are the Strategic Stage, the Tactical Stage, the Operational Stage, the Legislative Stage, and finally, the Implementation and Review Stage (Sawyer, 1996). Between the stages and phases, there are linkages and feedback loops, which are aimed at reflecting a flexible policy development process. The GTPP has three main objectives: the first is to encourage specific consideration of tax policy, the second objective is increase the transparency of the tax policy process, and the third is to clarify the responsibilities and accountabilities of Inland Revenue and the Treasury, who are both involved in the tax policy process (Sawyer, 1996). A diagram setting out the GTPP process is provided in Appendix 4.

2.5.3 Summary

The tax policy process can be complex, with many different groups and actors influencing policy-making outcomes. However, New Zealand provides a structured way for third parties and the public to have input into the process via the GTPP, resulting in the drafting of higher quality legislation. Notably, the LTC regime was only one of two major tax changes not to follow the GTPP.

2.6 A Brief Review of Tax Compliance Cost Literature

2.6.1 Overview

There is a significant body of literature that exists on tax compliance, which in turn has been subject to differing definitions and interpretations. Tax compliance imposes a cost upon businesses; with small businesses being those that are impacted the most due to them being regressive (Sandford & Hasseldine, 1992). Tax compliance (or non-compliance) results due to numerous different factors and aspects (Jackson & Milliron, 1986; Richardson & Sawyer, 2001). One of these is the complexity of tax legislation.

2.6.2 Introduction

Taxpayer compliance is a growing problem globally, with no panacea (McKerchar & Evans, 2009). Tax compliance describes a taxpayer's willingness to pay tax (James & Alley, 2002) and that includes not only the filing of all required returns at proper times, but also that the returns are filed accurately, that is, they report the tax liability required by legislation (Long, Swingen, Roth, Scholz, & Witte, 1991). In contrast, non-compliance refers to taxpayers who report their taxable income incorrectly, whether this was intentional or unintentional. An example of non-compliance is tax evasion, a deliberate and illegal attempt to reduce tax liability. Non-compliance may also include tax avoidance, depending on the interpretation of non-compliance adopted. This is because whilst tax avoidance is legal, it is not necessarily in the spirit of the law (James & Alley, 1999). Due to differing interpretations of non-compliance in previous literature, there have been inconsistencies in research findings (Richardson & Sawyer, 2001).

2.6.3 Tax Compliance Costs

One of the earliest authors to associate a cost with tax compliance is Smith (1910), who propounded four canons of taxation: equity, certainty, convenience of payment and economy in collection. Amongst these four canons, certainty and convenience of payment were wholly concerned with tax compliance costs, whilst economy in collection was concerned with both the collection and efficiency costs of tax (Tran-Nam, 2015). Compliance costs are different to administrative costs, and are incurred by taxpayers in efforts to comply with tax legislation (Sandford & Hasseldine, 1992). Conversely, administrative costs are those incurred by revenue authorities in collecting tax (Sandford, Godwin, & Hardwick, 1989).

Compliance costs can also be categorised as those that are internal or external to businesses (Hanefah, Ariff, & Kasipillai, 2002). Internal costs relate to those incurred within the organisation to meet taxation requirements. Conversely, external costs relate to the engagement of services outside the organisation, such as those provided by accountants or lawyers. A differing categorisation of compliance costs involves breaking down the cost on the basis of how the burden is imposed on taxpayers. Examples include time, monetary and psychological compliance costs (Evans & Tran Nam, 2014). The majority of studies have

focused on time and monetary costs, due to the difficulty in measuring psychological compliance costs (Woellner, Coleman, McKerchar, Walpole, & Zetler, 2007). Further ways to categorise compliance costs is by whether they are commencement (start-up) costs, temporary costs or recurrent costs (Sandford et al., 1989).

Compliance costs arise for a number of different reasons. Perhaps the most important cause of tax compliance costs is the complexity of legislation, which is discussed in more depth in the next section. Other drivers of tax compliance costs include the administration of the revenue authority itself, tax accounting rules and regulations, and international tax issues (Eichfelder & Vaillancourt, 2014). 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 (Lignier, Evans, & Tran-Nam, 2014).

It is also widely acknowledged that smaller businesses have a greater burden of tax compliance costs. This is due to the regressive nature of compliance costs, that is, smaller businesses experience a larger cost burden in comparison with larger businesses (Sandford & Hasseldine, 1992; Colmar Brunton, 2005). In fact, large businesses often gain benefits in complying with tax legislation (Tran-Nam, Evans, Walpole, & Ritchie, 2000). These include managerial benefits, where compliance with tax legislation results in the production of managerial accounting information (Lignier, 2006). Other benefits often gained by larger businesses (but not exclusively) include tax deductibility (compliance costs can often be tax deductible) and cash flow benefits (due to differences in timing) (Tran-Nam et al., 2000). Additionally, some literature also points to non-compliance from small businesses offsetting the regressive nature of compliance costs (Slemrod, 2004; Morse, Karlinsky, & Bankman, 2009). On the contrary large businesses may also have shorter deadlines to meet their tax obligations.

2.6.4 Summary

Tax non-compliance is a global problem, and is influenced by many variables. Tax compliance involves both the accurate and timely filing of tax returns. This often comes at a cost to taxpayers, which are referred to as compliance costs. These can be categorised in different ways, and have a regressive nature. This means that small businesses experience a larger cost burden in comparison to larger businesses.

2.7 Tax Complexity Literature

2.7.1 Introduction

The complexity of tax legislation has been recognised as a factor that impacts on non-compliance with taxation legislation (Jackson & Milliron, 1986; Strader & Fogliasso, 1989). Previous studies have found that tax complexity has mixed results regarding tax non-compliance (Jackson & Milliron, 1986; Richardson & Sawyer, 2001; McKerchar, 2003). However, research has indicated that tax complexity generally has a detrimental impact on tax compliance, irrespective of whether non-compliance is intentional or unintentional. This is because voluntary compliance is decreased by complexity, and this is an important factor in a self-assessment tax system, such as that in New Zealand (James & Alley, 2002; Jamieson, 2011).

2.7.2 Tax Complexity

Despite the notion that tax complexity has a negative impact on taxation compliance, numerous studies have adopted differing definitions of what complexity actually is. For example, Slemrod (1988) defines tax complexity by using four core attributes: predictability (certainty of tax law), enforceability (tax administrative costs), difficulty (computational tax compliance costs) and manipulability (tax planning costs). Conversely, an alternative definition is based on a process approach, which classifies tax complexity by where it occurs in different stages of the tax system (Evans & Tran-Nam, 2010). Studies have also drawn the distinction between effective complexity,³ and legal complexity⁴ which is based around the principle of certainty (Tran-Nam, 1999).

Furthermore, whilst previous studies have found that tax complexity is undesirable in general, there are sometimes situations where complexity is necessary or beneficial. Walpole (2015) argues that complex tax provisions can create greater operational or administrative simplicity, and often increase equity in the tax system. In fact, there are often trade-offs

³ Legal complexity refers to the level of difficulty associated with reading and understanding particular tax laws (McKerchar, Meyer, & Karlinsky, 2006).

⁴ Conversely, effective complexity is proposed as being the difficulty associated with determining the correct tax liability (McKerchar et al., 2006).

between taxation simplification and other objectives or aims of the tax system (Fleming, 2015).

2.7.3 Tax Complexity in New Zealand

New Zealand commenced a rewrite project of income taxation legislation in 1993. This project was aimed at simplifying income taxation legislation by rewriting legislation using plain English drafting so that readability was increased. However, the underlying core concepts of New Zealand's taxation system were retained, similar to rewrite projects in other jurisdictions (Sawyer, 2013c). Due to this, the rewrite project reduced legal complexity, but not other forms of complexity. This has resulted in significant readability improvements in New Zealand's income tax legislation (Saw & Sawyer, 2010). One of the major reasons for this improvement in readability is due to there being a uniform commitment from all parties to simplification (Budak, James, & Sawyer, 2016). This is underpinned by the GTPP which, as previously mentioned, provides for additional transparency and consultation.

However, literature indicates that there is still a level of complexity present in New Zealand's tax legislation, despite legal complexity being reduced. A contemporary example of literature can be found in Gupta and Sawyer (2015), who examined tax practitioners' perceptions of complexity in New Zealand's tax system. This study concluded that, overall, tax practitioners perceive New Zealand's tax legislation to be complex. Notably, tax complexity is more of an issue for small-medium enterprises (SMEs), which incur higher proportionate compliance costs (Budak et al., 2016). Extant literature has also contended that flow-through entities such as LAQCs and LTCs create unavoidable complexity, especially when compared to traditional structures (Freudenberg et al., 2012).

2.7.4 Summary

Overall, it is accepted that the complexity of tax laws has a direct relationship with non-compliance: as complexity increases, compliance (both intentional and unintentional) decreases. Whilst efforts have been made to simplify tax legislation in New Zealand, these have focused only upon legal complexity. Literature contends that LAQCs and LTCs were, and are, more complex than other taxation structures when considering various definitions of complexity.

2.8 Tax Practitioner Literature

2.8.1 Introduction

Tax practitioners are referred to by numerous names and titles, depending on the jurisdiction in which they operate. Common names include tax professionals, tax preparers, tax accountants, tax lawyers and tax agents (Gupta, 2015). Tax practitioners are a dynamic group, encapsulating individuals, businesses and professional groups who provide a range of tax related services for their clients.

Unlike some jurisdictions there is no statutory definition of what a ‘tax accountant’ or ‘tax practitioner’ is in New Zealand. Anyone is able to engage in providing tax services without satisfying legal requirements. In comparison, who can be a tax agent in Australia is highly regulated (McKerchar, Bloomquist, & Leviner, 2008). In New Zealand, the only ‘requirement’ to be a tax agent is provided in section 34B (2) of The Tax Administration Act 1994. This section defines a tax agent as someone who prepares annual income tax returns for ten or more taxpayers. As at March 2015 there were 5,400 registered tax agents in New Zealand, who collectively had almost 2.6 million clients (Inland Revenue Department, 2016c). This indicates a strong reliance on tax practitioners within New Zealand.

2.8.2 The Role of Tax Practitioners

A tax practitioner has an important role in the tax system, especially regarding tax compliance. Tax practitioners provide a link between taxpayers and the revenue authority (Gupta, 2015). 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 (Erard, 1993). This is due to tax practitioners having a greater knowledge of tax laws and procedures than that of the average taxpayer (Kaplan, Reckers, West, & Boyd, 1988).

Tax practitioners are often regarded as “gatekeepers” to the tax system for taxpayers (Hite & McGill, 1992; Newberry, Reckers, & Wyndelts, 1993; Tan, 1999). Tax practitioners have a duty to assist in upholding the integrity of the overall tax system, and most of the work

undertaken by tax practitioners involves compliance with rules and legislation (Gupta, 2015). Literature indicates that when tax legislation is unambiguous, tax practitioners take the role of an enforcer in the tax system. Conversely, when tax legislation is ambiguous, tax practitioners tend to exploit the tax system more (Klepper, Mazur, & Nagin, 1991). Pickhardt and Prinz (2014, p. 2) summarise the role of a tax practitioner as “on the one hand they are allies of taxpayers, on the other hand they have a legal obligation to obey tax laws when professionally advising taxpayers”.

2.8.3 Taxpayers’ Rationale for Engaging Tax Practitioners

Previous research suggests that there are various reasons taxpayers engage the services of a tax practitioner. These include to deal with the complexity of tax legislation, lack of time, fear of penalties and to file an accurate return (Hite & McGill, 1992). However, there are numerous other factors associated with the use of tax practitioners. These are summarised in Table 2.6, and are in addition to those in Hite and McGill (1992).

Table 2.6: Factors Associated With The Use of Tax Practitioners

	Study
Older	Collins, Milliron, and Toy (1990), Dubin, Graetz, Udell, and Wilde (1992), Slemrod and Sorum (1984)
Self-employed	Long and Caudill (1987), Dubin et al. (1992), Christian, Gupta, and Lin (1993), Slemrod and Sorum (1984)
Tax law complexity	Long and Caudill (1987), Collins et al. (1990), Dubin et al. (1992), Christian et al. (1993), Sakurai and Braithwaite (2001)
Time cost	Christian et al. (1993), Frischmann and Frees (1999)
Income level	Long and Caudill (1987), Collins et al. (1990), Christian et al. (1993)
Audit anxiety	Dubin et al. (1992), Collins et al. (1990)
Tax rates	Long and Caudill (1987), Christian et al. (1993)
Types of income	Long and Caudill (1987), Dubin et al. (1992)
Number of exemptions or deductions	Dubin et al. (1992)
Low tax knowledge	Dubin et al. (1992)
Less educated	Slemrod and Sorum (1984)
Unmarried	Slemrod and Sorum (1984)
Tax return prepared correctly	Collins et al. (1990), Hite, Stock, and Cloyd (1992), Tan (1999), (Sakurai & Braithwaite, 2001), (Tan, 2006)
Avoid serious penalties	Hite et al. (1992), Tan (1999), (Doyle, Frecknall-Hughes, & Summers, 2009)
Pay least tax required	Collins et al. (1990), Hite et al. (1992), Tan (1999), (Tan, 2006)
Reduce chances of being audited	Hite et al. (1992), Tan (1999), (Book, 2008)
Effort minimisation	Collins et al. (1990)
Social responsibility	Collins et al. (1990)

Source: Adapted from Tan (2009 p. 26).

2.8.4 Taxpayers' Preference for Advice

Extant literature indicates that the majority of taxpayers who engage the services of tax practitioners have a preference for conservative advice (Hite et al., 1992; Tan, 1999; Sakurai & Braithwaite, 2003). For example, Sakurai and Braithwaite (2003) surveyed taxpayers in Australia and found that taxpayers preferred tax practitioners that displayed competency, honesty, were risk averse, and whom they could trust to keep them out of legal “trouble”. However, literature also indicates that taxpayers who normally prefer conservative advice may actually defer to the expert opinion of tax practitioners who take more aggressive positions (Tan, 1999). Regarding aggressiveness, this is sometimes at the discretion of the taxpayer to advise their tax practitioner how to act. In other circumstances the tax practitioner instigates an aggressive tax position on behalf of their clients (Tan, Braithwaite, & Reinhart, 2016). Other literature explores the links between differing factors and variables and a taxpayer's preference for advice. For example, Coyne and Smith (1987) found that the size and structure of a tax practitioners firm influenced taxpayers preference for advice.

2.8.5 Effect of Practitioners on Tax Compliance

Previous literature has indicated that tax practitioners have a mixed impact on tax compliance. Earlier studies conclude that the use of tax practitioners results in lower tax compliance, and lower tax liabilities being reported (Smith & Kinsey, 1987; Erard, 1993). However, more recent studies have indicated that the use of tax practitioners has a positive effect on tax compliance (Tomasic & Pentony, 1991; Hasseldine, Kaplan, & Fuller, 1994; Hite & Hasseldine, 2003). A notable point is that taxpayers may avoid disclosing the full extent of their tax position to their tax practitioner. If this is the case, tax practitioners cannot be blamed for non-compliance (Book, 2009).

2.8.6 Summary

Whilst there is a range of potential definitions for who is a tax practitioner, there is no denying that tax practitioners have an important role in the tax system. This role varies from being a “gatekeeper” of the tax system, to being “an ally of the taxpayer”. Taxpayers engage the services of tax practitioners for a multitude of reasons, including the complexity of legislation, to ensure that their tax return is completed accurately, and to save time.

Taxpayers prefer advice that is risk-averse, but literature has indicated that if aggressive advice is received from tax practitioners, this may in fact be preferred. Additionally, contemporary literature contends that the use of tax practitioners has a positive impact upon tax compliance.

2.9 Chapter Summary

This chapter examined a range of literature relevant to the thesis topic. There have been no empirical studies that have focussed on LTCs, and very few studies on QCs/LAQCs. The few studies on QCs/LAQCs indicate that they have resulted in increased compliance costs for those that use them. Alongside this, the lack of literature in this area indicated that this is a relatively under-researched topic.

Legislative changes to QCs/LAQCs and LTCs were also detailed in this chapter. Of importance is that the QC/LAQC reforms did not utilise the GTPP process, which is widely regarded as a beneficial process. Instead, the changes were implemented through a supplementary order paper. Various amendments have been made to LTCs since inception, with major changes being enacted recently.

Compliance costs are defined as the cost of complying with tax legislation, and can take a number of different forms. Notably, compliance costs are regressive and disproportionate, with smaller businesses facing greater costs in proportion to their size. One significant cause of compliance costs is the complexity of tax legislation. Because of this, there has been a global effort to reduce the complexity of tax legislation. New Zealand has undertaken a rewrite project aimed at addressing this issue, but there is still a level of complexity present in New Zealand.

This level of complexity is one reason that taxpayers engage the services of a tax practitioner. However, there are numerous others, including to save time and to ensure an accurate tax return. Taxpayers generally prefer advice that is risk-averse, but in some cases aggressive advice is preferred. Generally, the use of tax practitioners by taxpayers results in reduced compliance costs.

Chapter 3: Research Questions, Design and Methods

3.1 Introduction

This chapter introduces the research questions and outlines the methods used to answer these questions. Because the aim of the study is to examine tax practitioners' perspectives, semi-structured interviews will be utilised. Thus, details of interviews and interviewees are provided in this chapter. This chapter also outlines the ontological and epistemological approaches used in this research. Because this research is seeking tax practitioners' perspectives, an interpretivist approach will be adopted.

As well, this chapter details the theoretical framework that is used to assist in the interpretation of results. Institutional theory has been utilised as it shows how different institutions' impact upon closely held tax policies.

3.2 Research Questions

This thesis addresses the following research questions:

- RQ 1: What types of businesses typically use the LTC regime?
- RQ 2: Based on their experience dealing with clients, do tax practitioners believe that the LTC regime has reduced compliance costs compared with QC/LAQCs, as well as compared with other structures?
- RQ 3: To what extent do tax practitioners recommend the adoption of the LTC regime to clients?
- RQ 4: Overall, what is the primary reason (or motivation) for clients to utilise the LTC regime?
- RQ 5: Do tax practitioners believe the changes to the LTC regime will decrease compliance costs? Why or why not?

3.3 Research Methodology

3.3.1 Ontology and Epistemology

This thesis takes an interpretivist approach. This approach is characterized by the belief that there are differences between people and objects in natural and social science (Bryman & Bell, 2015). As a consequence, a positivist approach is inappropriate. Instead, social reality is viewed as being emergent, subjectively created and objectified through human interaction (Chua, 1986). From an ontological perspective, it is impossible for reality to exist independently of the researcher; instead they are intertwined (McKerchar, 2010). Similarly, from an epistemological perspective, knowledge is socially constructed rather than objectively constructed. This belief extends to the research subjects as this research is seeking their interpretation of the LTC regime and changes associated with it. Therefore, the interpretive paradigm is the one that will be most likely to provide the insights desired from this research.

3.3.2 Theoretical Framework

This thesis draws on institutional theory as its theoretical framework. Institutional theory “facilitates analysis of how the state, interest groups and individuals, impact on the tax policy area, and the degree to which policy outputs reflect the preferences and influence of such groups” (Marriott, 2010, p. 12). Institutional theory follows “distinctive forms, processes, strategies, outlooks, and competencies as they emerge from patterns of organizational interaction and adaptation” (Selznick, 1996, p. 2). Institutions themselves can adopt different forms such as formal government structures, legal institutions or social institutions. Institutional theory posits that institutions themselves do not determine behaviour. Instead, they provide a context that helps in understanding why actors make the choices that they do (Marriott, 2010). In the context of this thesis, institutional theory enables analysis of how Parliament, Inland Revenue and tax practitioners, have had an impact on closely held company legislation. As well as this, institutional theory assists with explaining how closely held company legislation reflects the preferences and influences of such groups.

Institutional theory can be split into two main categories: old institutionalism and new institutionalism. Old institutionalism is concerned with the structure of institutions, and how the structure is determinative of behaviour (Peters, 1999). Notably, structure in the context of old institutionalism generally refers to formal features of the political system such as the constitution (Oats, 2012). Old institutionalism takes a holistic view, and is primarily focused on the description of institutions (Peters, 1999). Furthermore, old institutionalism is largely non-theoretical (Oats, 2012).

New institutionalism emerged largely due to shortcomings of old institutionalism. New institutionalism itself contains at least six different types,⁵ and for the purposes of this thesis, historical institutionalism is utilised. Historical institutionalism has particular relevance to tax policy, as insights into the key explanatory variables in the tax policy can be provided (Oats, 2012). Historical institutionalism is concerned with the past, but there is also emphasis placed upon the historical process (Ma, 2007). This allows policy to be analysed across time, and ensures analysis is concerned with changes in policy rather than the changes within institutions themselves (Peters, 1999).

A key premise of historical institutionalism is that the policy choices made when a policy is initiated will have a continuing and largely determinate influence over that policy into the future (Peters, 1999; Oats, 2012). This is known as path dependency, as when an institution embarks upon a path there is an initial tendency for the initial policy decisions to persist. The path may change or alter, but often a substantial amount of political pressure is required for change to occur (Peters, 1999; Oats, 2012). Another key premise of historical institutionalism is critical junctures. Critical junctures allow rapid change when required, such as during a crisis. This may see institutions deviate from a set policy path, but vice-versa, may place an institution on a new policy path that is difficult to change (Peters, Pierre, & King, 2005). Additionally, historical institutionalism is concerned with the distribution of power among institutions (Oats, 2012). The relevant institutions are discussed in the next section.

⁵ These include normative institutionalism, rational choice institutionalism, historical institutionalism, empirical institutionalism, international institutionalism and societal institutionalism (Peters, 1999).

3.3.3 Institutions

Institutional theory is also premised on the idea that individual capacity is constrained or empowered by the institutions from within which individuals operate (Marriott, 2010). In addition to this, political institutions are often made up of individuals with interests and views that are aligned. Thus, political institutions are not neutral environments; they instead act as a vehicle for certain types of activity and provide constraints as to what forms the activity will adopt (Marriott, 2010). Institutions can adopt numerous forms, including “formal institutions” and “social institutions” (Steinmo, Thelen, & Longstreth, 1992). In relation to closely held company legislation, the institutions of Parliament, Inland Revenue, and tax practitioners have all had an impact. Parliament and Inland Revenue are “formal institutions”, whilst tax practitioners are a “social institution”.

3.4 Method

3.4.1 Qualitative Research

Due to the research questions, a qualitative research approach is more appropriate. Qualitative research is concerned with words rather than numbers (Bryman & Bell, 2015), and recognises differences between people and the objects of the natural sciences. Thus, a qualitative approach allows events in the social world to be viewed through the eyes of the people under study, who in this case are tax practitioners. As well as this, quantitative research would restrict the level of explanation that can be gathered, which is especially vital when considering tax practitioners themselves are the interview respondents. Human ethics approval was sought for this research and approval was given.

3.4.2 Document Analysis

This thesis utilises documentary analysis, which has been used in conjunction with the interviews. The vast majority of documents analysed are public documents such as Acts of Parliament and officials’ reports. These provide rationale behind legislative changes and regimes, which is pertinent when taking into account the proposed theoretical framework. Documents are assessed using the four criteria suggested by Scott (1990): authenticity,

credibility, 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 (Bryman & Bell, 2015). In terms of credibility, public documents have the potential to be biased, as they are prepared by institutions for certain, specific purposes. This bias can reveal interesting insights but the researcher must also be careful in treating documents such as this as true depictions of reality. By combining documentary analysis with interviews, triangulation helps the researcher assess the credibility of any documents analysed. There is also the question of representativeness, but in the context of qualitative research this is not as important because no case can be representative in a statistical sense (Bryman & Bell, 2015).

3.4.3 Interviews

Part of this thesis involved carrying out interviews with tax practitioners. Interviews aligned themselves most closely with the theoretical framework as they allowed tax practitioners to give their own perspective on closely held company regimes in New Zealand. Interviews allowed the researcher to gather rich data from people in various roles and situations (Myers, 2009). Specifically, interviews were conducted in a semi-structured fashion, with the majority being conducted over the phone. One interview was conducted face-to-face. Interviews were conducted with 12 tax practitioners, with each being 30 to 90 minutes in length. Additionally, one email response was received, providing 13 usable responses. Interview respondents were asked if they consented to being recorded with an audio-recording device prior to the interviews. The researcher transcribed each of the interviews within a week of completing that particular interview. Alongside audio recording, brief notes were taken by the researcher during the interviews.

An interview guide was used to ensure any topics or areas were not omitted. Instead of being formal and rigidly structured, the interview guide was flexible and there was no set order in which questions were asked. This helped overcome issues with artificiality; interviewees had more scope to answer questions, and were not pressured into providing responses (Myers & Newman, 2007). As well as this, the interview guide was changed and updated as interviews progressed. Additionally, the interview guide was piloted with the researcher's employer who is a tax practitioner. The responses garnered from this were used to improve upon the

interview guide and provide additional areas for exploration. The interview guide is attached in Appendix 2.

Once the interviews were transcribed, the researcher compared them with a view to identifying themes and trends. Conflicting viewpoints across tax practitioners were also noted. This analysis was done using NVivo, which is a qualitative data analysis software package. These insights gained were considered in relation to prior literature and, perhaps more importantly, government documents relevant to closely held companies. An important point is that many tax practitioners interviewed were involved in writing submissions on the most recent closely held company changes.

3.4.4 Interviewees

In order to interview tax practitioners, it must first be defined who tax practitioners are. Various academic studies have involved tax practitioners; however, each has used differing definitions of what a tax practitioner actually is. Gupta and Sawyer (2015) provide examples of these differing definitions, including tax preparer, tax accountant, tax lawyer or tax agent. For the purpose of this study, a broad definition of tax practitioner was adopted. The definition of tax practitioner covered tax preparers, tax accountants, tax lawyers and tax agents, provided that they held membership of a professional body (such as Chartered Accountants Australia and New Zealand (CAANZ), Certified Practising Accountants (CPA) and the New Zealand Law Society).

For the purposes of this study, twelve 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. Whilst most of the interviewees had similar roles and were at similar career stages, this was necessary as interviewees who had experienced both the QC/LAQC and LTC regimes were targeted. Additionally, one tax practitioner provided email responses to the interview guide, providing a total of 13 usable responses. The firms employing these practitioners were a mix of Big 4 firms, mid-tier firms, tax consultancy practices, tax barristers and small accounting firms. This provided a number

of different perspectives and resulted in the triangulation of subjects (Rubin & Rubin, 2012). A full breakdown of the interviewees is provided in Table 3.1.

Interviewees were recruited through the Tax Team Leader (now New Zealand Head) of Chartered Accountants Australia New Zealand, Peter Vial. A list of potential interviewees was provided to the researcher, and prospective interviewees were contacted by email, with the interview guide, information sheet and consent form attached. Interviews were then arranged at a suitable time. This resulted in the recruitment of four interviewees. Searching online for tax practitioners identified the remainder of the interviewees. Once practitioners were identified, they were contacted via email, with the interview guide, information sheet and consent form attached. If they agreed to be interviewed, a time was organised for a phone interview. In all interviews, the consent form was returned prior to commencement, and interviewees were given a chance to ask any questions that they had before the interview commenced.

After thirteen interviews, saturation of information occurred; no new data was gleaned from additional interviews (Guest, Bunce, & Johnson, 2006). Tax practitioners were interviewed only once, mainly due to time constraints; however, it would have been interesting to interview the same practitioners after the new LTC rules had come into force, and this could form the basis for future research.

Table 3.1: Interviewees

Reference	Type of Organisation	Gender	Position	Location	Method
Practitioner A	Tax advisory firm	Male	Partner	Auckland	Phone
Practitioner B	Large accounting firm	Male	Partner	Auckland	Phone
Practitioner C	Barrister sole	Male	Barrister sole	Provincial centre	Phone
Practitioner D	Large accounting firm	Male	Director	Provincial centre	Phone
Practitioner E	Tax advisory firm	Male	Partner	Wellington	Email response
Practitioner F	Large law firm	Male	Partner	Wellington	Phone
Practitioner G	Barrister sole	Female	Barrister sole	Wellington	Phone
Practitioner H	Large accounting firm	Male	Partner	Wellington	Phone
Practitioner I	Mid-tier accounting firm	Male	Partner	Provincial centre	Phone
Practitioner J	Tax advisory firm	Male	Partner	Christchurch	Phone
Practitioner K	Small accounting firm	Male	Partner	Christchurch	Face-to-face
Practitioner L	Mid-tier accounting firm	Male	Partner	Dunedin	Phone
Practitioner M	Mid-tier accounting firm	Female	Manager	Dunedin	Phone

3.5 Chapter Summary

This chapter outlined the research methodology used in this thesis. An interpretivist approach is used as it is the most appropriate regarding research goals, which was to explore tax practitioners' perspectives on closely held companies. Additionally, due to the nature of tax legislation in New Zealand, an appropriate theoretical framework is institutional theory. Specifically, historical institutionalism is used as it explains key variables in the tax policy process and allows historical changes to be analysed. Regarding closely held company legislation, the most relevant institutions are Parliament, Inland Revenue and tax practitioners. Parliament and Inland Revenue are formal institutions, whereas tax practitioners are a social institution.

In terms of method, a qualitative method involving document analysis and semi-structured interviews was utilised. Document analysis was conducted on relevant policy documentation using the guidelines provided by Scott (1990). Thirteen tax practitioners from a range of firms and locations were interviewed using semi-structured interviews and with an interview

guide. This interview guide was not a rigid document; rather it was updated and modified as interviews progressed. The interview guide was first piloted on the author's employer. Twelve interviews were conducted over the phone, one was conducted face-to-face and one usable response was received by email. Four interviewees were recruited after the author was provided a potential list from Tax Team Leader (now New Zealand Head) of Chartered Accountants Australia New Zealand, Peter Vial. The rest of the interviewees were recruited after searching online. Human ethics approval was sought and gained prior to the interviews taking place.

Chapter 4: Interview Findings

4.1 Introduction

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.

4.2 Findings

4.2.1 Use of LTCs

4.2.1.1 Typical Uses

As a starting point, the researcher sought to determine typical scenarios where a LTC 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 LTCs were useful in this context:

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)

In my experience, mainly ... it is used by people that are in rentals or commercial property. (Practitioner C)

In my experience, it would be instead of smaller families who have investment properties, they tend to go for it. (Practitioner G)

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, 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 LTCs were best used for companies 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 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 LTCs 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 LTCs is for international tax planning and structuring. 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 notion that LTCs were 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)

4.2.1.2 Reasons For Use

Because various practitioners view LTCs as being used for different purposes and situations, the reasons for use also vary. However, the most common reason for using LTCs 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 LTCs:

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, Practitioners C, H, and L did not view limited liability as being important in deciding whether to use the LTC structure:

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)

The limited liability is probably only beneficial in a small number of those structures. So if you take ... your rental property stuff, there's virtually no benefit in limited liability in those structures. (Practitioner L)

Practitioners indicated that in an international context, LTCs are used as they 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)

Yeah, so, so with the normal companies, if you establish a company to operate in Australia for example, you will obviously get taxed in Australia on the Aussie sourced earnings, and when you distribute those back to New Zealand, they may not attract tax when they are paid out of the Aussie company, but when the New Zealand shareholder seeks to distribute those earnings the second layer of tax kicks in at that stage. Now with a look-through company we can overcome the one of the two layers of taxation. (Practitioner A)

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

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 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 LAQC/QCs, 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)

4.2.1.3 Recommendation of Use and Taxpayer Knowledge

Tax practitioners stated that in almost all circumstances, it was they who recommended clients use the LTC structure. 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 be an 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 LTCs:

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 LAQCs/QCs than LTCs, even though the LAQC/QC regime has been repealed for over five years:

I've been in so many meetings where I have mentioned an LTC, or so many, I've been at meetings where I've 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)

Most clients don't actually understand what the LTC regime is, other than thinking that it's basically an evolution of the qualifying company regime. (Practitioner G)

4.2.1.4 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 LTCs were popular. Practitioner A was of the view that most LAQCs chose to transition to a LTC:

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 LTCs were not as popular as LAQCS:

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)

4.2.2 Advantages of LTCs

4.2.2.1 Overview of Advantages

The advantages of LTCs 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 LTCs, such as simplicity and the ability to use LTCs to maximise interest deductibility.

4.2.2.2 Simplicity

Another advantage posited by some practitioners was simplicity. Practitioner J and K were of the opinion that LTCs were 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)

4.2.2.3 Separation and Interest Deductibility

Practitioners A, E, and J were of the belief that an advantage of LTCs was the ability to use them to restructure affairs. LTCs 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)

Key advantage is separation to determine funding that is relating to the business. When advising clients that borrow funds, and can repay debt but will/may one day want to draw further funds, need to have separation to confirm interest deductions. Having a partnership or sole proprietor structure does not allow this. Having a normal company allows this, but this is not efficient when there are tax losses. (Practitioner E)

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)

4.2.3 Disadvantages of LTCs

4.2.3.1 Overview of Disadvantages

As well as advantages of LTCs, practitioners were also of the view that there were a number of disadvantages of LTCs. 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.

4.2.3.2 Loss/deduction Limitation Rule

The most commonly mentioned 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:

So, this calculation of the owner's basis, and that sort of thing, and everything that goes into it, it's just not straightforward. And some of the capital contributions, the guarantees made and all that, but even within that calculation there's a number of fishhooks and areas you can go wrong. (Practitioner K)

The legislation around the look-through ... measurement is impracticable and I think that does create [extra] record keeping. (Practitioner D)

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 need historically anyway, or the current need for a basis calculation has caught people out. And a lot of people didn't actually comply properly with, but by the grace of god managed to still meet the requirements. The basis complication certainly added a complication that people didn't expect. (Practitioner M)

The other one is being the owner basis calculation and the loss limitation. (Practitioner I)

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)

Until recently, well, until the beginning of next year, another disadvantage was they'd actually been able to understand and then also to track the owners' basis which was, irrelevant in 99% of situations. (Practitioner J)

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)

4.2.3.3 LTC Eligibility Requirements

Practitioners also mentioned 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)

Practitioner views on LTC eligibility requirements are also discussed in subsections 4.2.7.2 and 4.2.7.5.

4.2.3.4 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 LTCs. Practitioner H thought this was a disadvantage as shareholders were subject to 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)

Absolutely, but even then you would then think: "well what then happens?" Because of course the problem with an LTC is you've got no control of income, well limited control of income allocation. (Practitioner K)

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)

Just the, well, I said at the start, the inability to have retained earnings, you have to bring out all the earnings through to the shareholders, which is kind of, there's no tax deferral or anything like that available through LTCs. (Practitioner C)

4.2.3.5 Shareholder Changes

Some practitioners also mentioned shareholder changes as being a disadvantage of LTCs. Shareholder changes can trigger a deemed sale and repurchase of the LTCs 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 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)

4.2.3.7 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 views on transparency are also discussed in subsection 4.2.7.5.

4.2.3.8 Poorly Drafted and Ambiguous Legislation

A final disadvantage raised by practitioners was the belief that legislation surrounding LTCs 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)

4.2.4 Complexity of LTCs

When practitioners were asked if LTCs were 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)

In a look-through company, you just don't know where they stand. There's some ... You know you say, "Oh, are LTCs complex?" Well of course it's complexity. (Practitioner D)

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 LTCs were 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 is 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)

4.2.5 Comparison to Other Structures

4.2.5.1 Similarity to Other Structures

Overall, most practitioners were of the view that LTCs were most similar to limited partnerships:

That would have to be a limited partnership in terms of the tax effects, because in most instances they're identical. Ordinary partnerships are also very close in terms of the tax characteristics except that you don't have this concept of owner's basis and you don't have the limitation liability. So, certainly LP's are designed to be most similar to an LTC. (Practitioner J)

Limited partnerships. Because they are essentially the same thing. We describe a look-through company as being a company pretending to be a partnership and a limited partnership as a partnership pretending to be a company. They are basically both corporate vehicles with look-through tax effectively. (Practitioner M)

Yeah. Well, it's probably, today, if you're answering it honestly, you'd probably say a limited partnership. Hopefully, with the Closely Held Company Bill passing shortly, then you'd more likely say a normal partnership. (Practitioner L)

Practitioner K was of the view that LTCs were most similar to traditional partnerships:

I guess partnership is the obvious one. Just the partnership, the fact that the income allocation and the loss allocation flows through, that's probably the major one. I guess the change is shareholding in an LTC is analogous to a change partnership in terms of some of those tax issues, so I'm asking that question. (Practitioner K)

4.2.5.2 LAQCs/QCs

All of the practitioners who were asked thought that LTCs were more complex than LAQC/QCs. Reasons for this varied, and included the loss/deduction limitation rule, issues around transparency, poorly drafted legislation, and the deemed asset sale rule:

Well I think they're complex compared to QCs. They're complex in terms of the uncertainty in those regimes. (Practitioner F)

Yeah, they are. Loss limitation rule, and probably some of the rules around eligibility and the whole look-through counted owner test and all that sort of thing and ... is more complex than ... [the] QC, LAQC rules. (Practitioner B)

Yeah, I think there's probably two or three things in it. One is the LTC attributes gross income and deductions, so at a technical level, it's a different beast. The LAQC attributed its net loss only. And so technically, if was looking at what each did, the LTC is more complicated. You then have got the loss limitation rule, which obviously the LAQC didn't have, and you've got this concept of how transparent an LTC is to

try and get your head around, whereas that never arose with a look-through a LAQC, its a company but its loss just flowed out. (Practitioner L)

Certainly, from a tax perspective, a technical tax perspective yes, they are. Because with the LAQCs if you exited the QC regime, nothing happened, you didn't have a deemed sale or anything like that. All that occurred was that you lost QC status and you didn't get to attribute losses any further. 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. So, you've got all that sort of added complication with LTCs, so they are definitely more complicated in that regard. (Practitioner A)

Yes, definitely, again because of the owner's basis calculation and the difficulty in understanding the capacity in which the shareholders are acting as an owner of the LTC, this is their personal capacity, we never had these issues with LAQC's or QC's. (Practitioner J)

4.2.5.3 Limited Partnerships

In regard to complexity, some practitioners were of the view that limited partnerships were more complex than LTCs:

They're not quite as flexible compared to LPs because of the restraints on the number of shareholders you can have. Those complexities are there. And it's also got a separate legal personality. It's a bit more complex to set up the LP because you've got to have a GP. (Practitioner F)

Practitioner F went on to state that it was less complex to form a LTC compared to a limited partnership, but the ongoing administration requirements were more complex:

It may be that it's lower compliance getting into it even if it's bigger compliance in terms of enforcing the number of shareholders rule once you're in it. (Practitioner F)

Conversely, Practitioner J did not think that limited partnerships were more complex than LTCs:

No, no. ... From a tax perspective, they're both rather equivalent in terms of tax complexity because they both have the loss limitation rule and the definition of owner's basis that goes along with it, but from a contracting or a commercial perspective a limited partnership is more complicated than an LTC. (Practitioner J)

Practitioner B also did not think limited partnerships were more complex than LTCs. This was because companies, such as LTCs, were more widespread than limited partnerships:

I guess because we're dealing with formation of companies, which is a very well understood and well-trodden path, that's very easily understood and then putting the LTC overlay on top of that, just adds a little bit of complexity on top of that but not a significant amount, whereas limited partnerships are still pretty uncommon because they are very much driven by the partnership agreement and so forth. It's more complex to deal with limited partnership... the agreements are generally all different as opposed to most companies [which] are similar and come out of a cookie-cutter. (Practitioner B)

Practitioners had mixed views on whether limited partnerships were substitutes for LTCs. Some practitioners stated that they were not, as the two regimes had different target markets:

LP regimes are more commercial. You know, LP I might use, especially when you've got cross border investors. That comes back to that because limited partnerships get recognised internationally as partnerships, but LTCs don't necessarily get recognised as being look-through. (Practitioner D)

What I tend to say to people is that the limited partnership regime was introduced to facilitate foreign investment into New Zealand, which was a group of sophisticated complex investors, who could handle complex regimes. Because the dollars are big. Whereas the LTC regime is for unsophisticated simple investors, where the dollars aren't so big, but as it stands today the regime is as complicated. (Practitioner L)

They are perceived like a sort of Toyota and a Ferrari. Different planes on different runways. Different markets, absolutely. LTCs are for small time SMEs, whereas with limited partnerships because you need a formal deed and they need to be registered companies effectively, they do tend to be used by those in the, at that sort of higher end. (Practitioner H)

Conversely, due to the similarities in each regime, Practitioner F viewed limited partnerships as being a substitute for LTCs:

In the area of the closely held business, then they're substitutes. (Practitioner F)

4.2.5.4 Traditional Structures

All practitioners thought that LTCs were more complex than traditional structures such as sole traders, partnerships and traditional companies. This was mainly due to the extra rules surrounding LTCs such as the loss/deduction limitation rule:

More complex than sole traders and partnerships. There are still capacity issues with partnerships to deal with, but you don't have owners' basis issues. So that's not so bad. Compared to ordinary companies you've got complications there in terms of the dividend rules and deemed dividends and so forth FBT is also more of an issue, because of divorcing and the owners from the business itself. So, there is a sort of calculation of dividends, withholding tax obligations and so forth, it's more complicated with an ordinary company structure in terms of getting wealth out of the structure. So, I think they're more complicated in many respects. (Practitioner J)

Then you'd say their regime is, today, quite a bit more complex because of the loss limitation rule. This isn't entirely true, but I'll say it anyway. I think there will be a perception that the true nature of the LTC is not as well understood as the true nature of partnership. In reality, I suspect the true nature of a partnership is not that well understood either, but people think they understand them. (Practitioner L)

In relation to sole traders, partnerships, traditional companies, I mean I think that LTC's are definitely more complicated than all of those really. It's an extra level and I guess the other thing from the financial reporting, still in our view, you have the sole traders and partnerships it's a little more straightforward. (Practitioner K)

Yeah, it's the owners' basis calculations, the loss limitation rules and stuff like that. It requires somebody to do those calculations to get the right result, whereas things like partnerships and stuff like that, it's just a lot easier to understand. (Practitioner G)

4.2.6 Qualifying Companies

4.2.6.1 QCs Yet to Transition

Practitioners had varying numbers of QCs that they acted for. Some had very few, or none:

I might have one of those, but that would be it. (Practitioner F)

No, no, no. I thought they all just opted into the LTC regime. (Practitioner C)

I'm going to go one client that was a qualifying company, was an LAQC and that's still a qualifying company. Most of the LAQCs, most of them sort of transitioned I think. (Practitioner B)

On the other hand, some practitioners had a substantial number of clients that still utilised a QC structure:

We do still have a reasonable number, they'd be the ones where there hasn't been any breach, there was no need to or no benefit in transitioning to the look-through company regime [or] they've ... got reserves, which are unimputed. (Practitioner M)

Our firm will have, yes because they tend to be in that sort of smaller SME type market. So yeah, there will still be qualifying companies that haven't transitioned

across, and those will tend to be qualifying companies, which have ... which are profitable. (Practitioner H)

QCs yet to transition, do you many clients? Yeah look we've still got, probably of that 180, 200, whatever the number of QC's that we used to have, the bulk of which would have been LAQC's as well, it was rare not to have them both; I think that became the default, rightly or wrongly, the people ticked both boxes and elected to be a QC and an LAQC, I think that was pretty much the experience in the days. I would say that probably of those, we probably had the eight to ten that went to the LTC's, I can't recall forming an LTC since then actually, we may have one or two. The vast majority of those would have remained QC's, we had a small number that took the option to exit and become a partnership or whatever. (Practitioner K)

Yeah, we still have 250 of them left. (Practitioner I)

Of those practitioners that still acted for clients with QCs, most stated that they would not be advising clients to transition to another structure unless it was mandatory. Practitioner I stated that this was for two reasons. First, because of the advantageous tax rules QCs have, and second, because any transition would not have the advantage of concessionary transitional rules:

No, I think most of ours will probably remain as a QC because they're a QC normally because of the holding assets that will hopefully make capital gains and they'll be wanting to access that capital gain without all the, if they're winding the company up. Some of them will have distributed past dividends or have changed the shareholding so they can't actually exit the QC regime without having bad tax implications so that they're stuck there basically. (Practitioner I)

Practitioners E, J, and L were also of the view that existing QCs should not transition unless it was mandatory because of the advantageous tax rules the structure provides:

Do not have any, but we would not transition from QC to LTC (why give up 28% tax rate?) (Practitioner E)

These days I'm not quite sure why you would. If you've got a QC then you probably wouldn't want to restructure and go into the LTC regime, because you've actually got something, which is, in most instances, superior to an LTC. (Practitioner J)

But yes, when we talked to IRD, they keep saying, "We don't understand why there's still 70 thousand qualifying companies out there, why they all haven't transitioned," and we say, "Because the regime you've given us doesn't give us the benefits that we need, and has these downsides to it." (Practitioner L)

Practitioner A also agreed with Practitioner I regarding the potential cost of exiting the QC regime:

Okay, and therefore if they were to now contemplate changing to a look-through company they would have unimputed retained earnings, which would result in an entry cost to them. So, I think they are unlikely to move to a LTC status. (Practitioner A)

If QCs had to transition to an alternative structure, practitioners gave a variety of responses as to which structure they would suggest clients transition to:

They will at some probably at some point become standard companies. (Practitioner M)

So, I suppose the only reason why you would actually ever want to transition from a QC to another form is that if you did have systemic losses, which weren't very useful in the QC, but you wanted to be able to access that at the shareholder level. In which case, then you would consider transitioning to an LTC outside of the grandparenting rules, but normally when you've got a QC you're not going to do anything with. (Practitioner J)

The ones that I know of, they will get into the LTC regime. (Practitioner G)

4.2.6.2 Advantages of QCs

The advantages of QCs were considered by practitioners to be the ability to get capital gains out of the company without liquidation, a lower effective tax rate (through the ability to quarantine losses and profits within company), and the perception that they are understood easily. The most commonly cited advantage of a QC by practitioners was the ability to extract capital gains without liquidation:

Well the big advantage of course is being able to get your capital gains out without having to liquidate the company so there's no worries about associated person capital gains, which is still the bane of many advisors and will be less so after these reforms go through. (Practitioner J)

I think the main advantage was you could take out your capital gains without the need to liquidate the company. (Practitioner A)

It comes back to the main benefit of the QC regime apart from the loss flow through was getting capital gains out without liquidating the company. (Practitioner B)

Practitioner H was of the view that the main advantage of QCs is the ability to quarantine losses or profits within the company, resulting in a possible lower tax rate:

They've got the ability to leave the income in the company and pay tax [at] 28 [percent]. (Practitioner H)

Practitioner D also shared this view:

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. If you like, that is free working capital for the business because you haven't checked the look-through company box.

Practitioners D and G were of the opinion that an advantage the QC regime provided was simplicity:

And in closely held situations Mum and Dad situation, Mum and Dad don't necessarily understand that and usually the qualifying company is therefore... so it's good to have an exempt dividend there because it just means one less thing to worry about charging interest on current accounts. (Practitioner D)

I think the advantage of, and I'm not sure I can call it an advantage, but the qualifying company regime was understood and it was something that had been around long enough and was understandable and, as such, used quite a bit and I think that was the benefit you could - every single accountant understood what a qualifying company was. It was easy to tax, it was easy to manage, and it was just a simpler regime. (Practitioner G)

4.2.6.3 Disadvantages of QCs

One disadvantage of QCs was considered by practitioners to be the yearly elections required by shareholders and directors to maintain QC status. Companies also need to re-elect into the QC regime after shareholding changes. Additionally, practitioners also considered the lack of an automatic interest deduction to be a disadvantage. The main disadvantage mentioned was the need to re-elect into the QC regime, and the difficulty businesses had in remaining in the QC regime:

If people forget to ask and they go, "Oh, we've got a new up and coming boy in the business. We've going to give him ten percent of the business," and if that was done and they don't tell the accountant and the accountant doesn't see that you need to do a QC election for the new shareholder, you'd lose your QC status. (Practitioner D)

But there's a couple little quirks in there, also there's the old beneficiaries becoming, ceasing to be minor, minors whatever or lack of sui juris. Though the other thing more particularly is the requirement that it distributes the dividend, allocates the dividends

of beneficiary income, you know it's the trust receives the dividend from the QC and that I have seen go wrong so many times. (Practitioner K)

Yeah. I mean, any time you make an election there's a risk you get it wrong. Suddenly liability springs up, and we've seen that with the QC regime over many years. You think you're a QC so you do things one way, and it turns out you're not. (Practitioner L)

The drawbacks are that it's easy enough to breach. And the effect is retrospective if you do. (Practitioner M)

As well as this, Practitioners B and D viewed the lack of an automatic interest deduction to be a disadvantage of QCs.

I think the only real drawback with the QCs is the lack of automatic interest deduction for companies. (Practitioner B)

Qualifying companies don't get automatic deductions for interest. You've got to track the borrowings to cover a particular nexus with income earnings to get your deductions and ordinary companies or non-qualifying companies get an automatic interest deduction. So, you just need to keep tracing your debt sources. (Practitioner D)

4.2.7 Changes to Closely Held Companies

4.2.7.1 Awareness of Changes

All of the practitioners interviewed were aware of the proposed changes for LTCs. Practitioner K was of the view the timing of the changes was poor, given that they were to be enacted from 1 April, and the deadline for tax agents to file returns for the previous financial year was 31 March:

You can just see the practicality, so what are we now, 16th March; we've got two weeks until the end of the year, we're rushing through the last 10% of painful clients who only just got their stuff in. You're under pressure, something like that goes through, you don't even think about it. (Practitioner K)

Practitioner M also made reference to the timing of the changes, mentioning that there was a substantial delay in enactment:

It was supposed to be introduced by Christmas but never mind. (Practitioner M)

4.2.7.2 Overall Views on Changes

Overall, most practitioners believed that the proposed changes to LTCs would make it a better regime:

I viewed it as positive because my major objection is the owner's basis calculation. And for our clients I think that will ease the administration, I would have thought. So, I think that's, from our perspective it appeared to me to be beneficial. (Practitioner K)

I think the changes that are in the process, well that should just about be law by now, will actually make the regime a little bit friendlier and less costly. Certainly would mean that we'd probably be slightly more inclined to use the LTC rules again. (Practitioner I)

I think on balance it's probably favourable because I think that not having to track the owner's basis is a big assistance and the issues there in tracking the number of owner's in the restrictions on the manner in which LTC's have set up, only affects a relatively small number of LTC's and mostly those changes are livable even though they are slightly inconvenient for some of our structures. So, I think on balance it's probably positive. (Practitioner J)

I think they're in the main very positive, so the big changes are taxpayer friendly. There are some smaller changes, which are taxpayer unfriendly. (Practitioner L)

However, Practitioner A disagreed:

I'd say no difference. Owner's basis simplifies it fantastic. Tick that one off, that's good. But counted owners makes it way more complicated, and you know, as I say, gives rise to the potential for some stuff ups down the track, so, so, one offsets the other. (Practitioner A)

4.2.7.3 Views on Specific Changes

All practitioners who commented on the proposal to restrict the coverage of the loss/deduction limitation rule were supportive of the change:

So, we've got the changes to the loss limitation rules, which abolishes them for most LTCs. Needless to say, we consider that to be a positive change, because it's pretty much a waste of time in the first instance. (Practitioner J)

Getting rid of the loss limitation rule is good and I know they've got specific circumstances and so forth, but I think it's moving in the right direction. (Practitioner G)

I think a lot of the loss limitation stuff was over blown from the beginning, but I think that it's a positive thing that they are doing now with that little change. That is actually something that people had to niggle about. It will be good if they effectively remove that from the picture. (Practitioner B)

Of the practitioners that commented on the proposal to tighten the eligibility criteria for LTCs, most did not support the changes. Some practitioners did not support the changes that were specific to the counted-owners test:

To me, they seem to be making that overly difficult. Right, and I think that there's more and more potential for clients to trip themselves up. You know they shuffle shares from individuals to a trust and because you now have to look at the trustees. And the distributions and those received previously it was, that's right, previously it was just who had received distributions of the LTC beneficiary income that was LTC

income, but now we have to look at all distributions. We've got to back, instead of back 3 years, we now have to back 4 years or something like that. It's just like ... that's so complicated. (Practitioner A)

So, I'm not particularly happy about that in terms of the changes they've made to the counted [owner] test I didn't really think we had to make those changes and because of the way in which they've done those changes, tinkering around with it you end up with these rather complicated transitional rules. So, while accountants now no longer have to track the owner's basis, they've got to be pretty careful on the counted [owner] test and that's become a little bit more complicated than what it was. (Practitioner J)

However, Practitioner H did not view the changes to the counted-owners test as being negative:

Because primarily LTCs are for sort of closely held sort of family type small businesses rather than ... So, I think having it, having some lesser onerous test or more onerous test is absolutely fine. (Practitioner H)

Other practitioners did not support changes that were specific to the restriction on foreign income:

The bits I don't particularly agree with is the restrictions on, if you have 50% or more of the shareholding owned by foreigners or non-resident, the restrictions on foreign sourced income and so forth. Yeah, and if you're going to try to encourage foreign investment into New Zealand then providing a physically transparent vehicle that, particularly high net worth, non-residents can use for investment, those sorts of changes are restricting that which is, in my view, not ideal. (Practitioner G)

Practitioner L shared a similar view on the restriction on foreign income. In this practitioner's view, the restriction was a result of international tax reform:

Which is driven by a little bit of paranoia at the IRD, and a little bit of BEPS stuff and international stuff about could these things be used to defraud other tax bases, so

that's where I'm talking there is the introduction of some criteria around foreign investors, and foreign income. (Practitioner L)

In relation to tightening LTC criteria, Practitioner J did not believe the restriction on charities using LTCs was necessary:

So, they've decided as a policy decision that charities shouldn't be able to use LTC structures and I think that's a bit disappointing. As long as you're not trying to do that to defeat the notion that charities shouldn't be direct shareholders in LTCs, at least they're not requiring a million people to go and modify their trust deeds. (Practitioner J)

However, Practitioner J was supportive on the restriction against corporate shareholders receiving distributions from LTCs:

I can sort of understand why they don't want corporate beneficiaries getting distributions from an LTC, because they can say, "you can just circumvent it by just having a trust as a shareholder and then the corporate is the beneficiary and possibly have a company as a defacto shareholder of the LTC." (Practitioner J)

Whilst the tainted capital gains rule only applied to LTCs in limited circumstances, all practitioners that commented on this were supportive of the change:

Well, that was obviously a pretty positive change. I've been trying to hammer tax policy on that change for at least 3 or 4 years. (Practitioner J)

Yeah, I didn't really see it in the LTC context, but certainly in ordinary company situations it would quite often be an issue, particularly in an historic context. It could come back and bite you if you weren't particularly careful about identifying the source of capital gains that have been sitting in the company previously as a result of a restructure. (Practitioner B)

But the tainted capital gain rule [removal] will be a big help for ordinary companies that's for certain, that's been a real bug-bear that one. (Practitioner I)

Only one practitioner, Practitioner J, commented on the proposed change to entry tax calculations for LTCs. This practitioner was supportive of the proposed change:

That stops what has been widely perceived as a loophole and I think it probably is. Although the government tried to justify it as an intended policy decision the first instance, so that you don't get away with a permanent tax advantage of your retained earnings capped at a 28% tax rate. (Practitioner J)

Another proposed change was to implement a continuity test for QCs. Practitioner J was of the view that this action was a step in the right direction, but did not go far enough:

Yeah, the continuity rules. That's because the uptake on LTC's was not as strong as the government suspected. They thought that they could phase out QC's. In my view, there's a strong argument to go and basically to kill off QC's and replace it by a special rule. (Practitioner J)

Practitioner D believed that this change was unnecessary:

So, if I had a qualifying company that you wanted to buy, you wouldn't buy a qualifying company, you would just buy an ordinary company and I don't think that's necessarily a good idea. (Practitioner D)

Table 4.1 is adapted from Table 2.4, and provides a summary of practitioner's views (where applicable) on specific proposed LTC rule changes.

Table 4.1: Views on Proposed LTC Rule Changes

Proposal	Practitioner												
	A	B	C	D	E	F	G	H	I	J	K	L	M
Tightening the eligibility criteria for look-through companies (LTCs)	-	-		-	-	-	-	+	-	-	-	-	
Modifying the entry tax calculation for LTCs so it is calculated at each shareholder's personal tax rate										+			
Restricting the coverage of the deduction limitation rule	+	+	+			+	+	+	+	+	+	+	+
Addressing concerns about how the debt remission rules work in relation to LTCs and partnerships			+						+				
Removing qualifying status for qualifying companies (QCs) that have a change in control of the company				-						+			
Narrowing the scope of the "tainted capital gains" rule	+	+			+				+	+			
+ = supports this change													
- = does not support this change													

4.2.7.4 Changes and Uncertainty

Some practitioners believed that the changes to LTCs would result in legal uncertainty for other practitioners. This was due to the requirement for other practitioners (such as those that are not tax specialists) to familiarise themselves with a new set of rules relating to LTCs:

So far, I guess it's probably a good thing, but every time they would change, and particularly when the people, like for the CAs that would typically have a lot of clients of LTCs, anything that tinkers with the regime like that can impose a huge compliance cost to bring everyone else up to speed. (Practitioner C)

Practitioner C also used the restriction of the loss/deduction limitation rule as an example to highlight this:

I mean probably good, but like anything when there's a tax law change, then there's a huge compliance cost for a lot of accountants that just got their head round doing loss limitation calculations. Now, we have to figure out whether we have to do them or not. (Practitioner C)

Practitioner L shared a similar view when asked if the changes were hard to keep track of:

Well, I'm reasonably deeply involved with them. So, from that aspect, no, but I imagine for a practitioner who is a bit further removed from it, yes. (Practitioner L)

4.2.7.5 Additional Changes

Almost all practitioners were of the view that changes additional to the ones proposed should be made to the LTC regime. One of these additional changes was in reference to the five counted-owners restriction:

There's some conceptual stuff that says if me and 20 mates can get together in a partnership, why can only me and five mates do it in an LTC? Because what the policy rationale is, is an LTC is a substitute for a partnership. And yet the partnership

can be broader than the LTC can because it doesn't have such a rigid set of rules around it in terms of five or fewer shareholders type of stuff. (Practitioner L)

The only other one has been there's obviously a limitation of five people. I'm involved with a vineyard where there's 10 of us. In the end, we just went through a simple partnership, which is not absolutely ideal. But we did that on the basis that one of our partners is the managing partner, he's out there all the time. For absentee vineyard owners not having someone actually actively involved would be a bit of a risk. So maybe the number of owners, they're trying to let people have limited liabilities still do things. (Practitioner I)

Probably the only other wrinkle would be to say that maybe the LTC regime should look at increasing the number of eligible owners. Maybe doubling it to ten or something. It's just to create a more easily used flow-through investment vehicle than an LP currently is for a situation where you've got more than five non-associates. (Practitioner B)

Practitioner E was of the view that the restriction on corporate shareholders for LTCs is unnecessary:

The key issue with LTCs is why do they have to be individual shareholders. Why can't say Contact and Meridian form a LTC? Generally, these corporates achieve the same by using an LP or by using a partnership of wholly owned corporates (more common). (Practitioner E)

On a different note, Practitioner C suggested that a change should be made to allow LTCs to do group offsets, which is when another company with similar company ownership can offset one company's losses against the others profits:

There should be an ability perhaps to do loss offsets, group loss offsets. I mean, there's no reason why there should disallow loss offsets within the group or company just because one of those companies happens to be an LTC. It doesn't seem to make a lot of economic sense, and I don't really understand the rationale for not allowing that. (Practitioner C)

Another change practitioners would like to see made to LTCs is to do with the transparency of the regime. Specifically, there is the perception that there needs to be clarity around exactly how transparent an LTC is or is not:

We've been banging on to the IRD for a long time that they need to articulate how transparent a look-through company is. Now, it's very easy to say that these things are transparent, but then you see the IRD come out with statements, which suggest that transparent doesn't mean transparent. And I don't understand what that means, and I work with these things in immense detail. So, we've told finance and expenditure select committee and the IRD that they should come out and articulate how these things look, but what we tend to get is the IRD reacting to questions on transparency with an answer, but that answer is not very well considered. (Practitioner L)

There still seems to be some conceptual confusion, much of it fueled by the IRD, on how the fiscal transparency provisions apply and there does seem to be an element of what we refer to as one-way transparency. So, the IRD has basically said, "Well, I know that all the assets are treated as being owned by the owners of the LTC, but I'm going to say that you own those assets in a different capacity, so the tax consequences still arise." (Practitioner J)

Practitioner B suggested that comparing and aligning the structure with a traditional partnership could clarify transparency:

The goal would be to make it on all fours with an ordinary partnership – that would be the comparison to pick up any differences between an ordinary partnership would work and how an LTC partnership might work under these new rules. (Practitioner B)

4.2.8 Overall Evaluation of Closely Held Company Regimes

4.2.8.1 Overall View of LTCs

Practitioners had varying perceptions of the LTC regime overall. The majority did not regard the regime as being successful:

I think it's been successful in that fewer people will use it. If that was the intention then great because, generally speaking, I mean, I would not even advise clients to use look-through companies almost purely because of the complexity if I had a new person coming in wanting to invest in an investment property and so forth I would probably ask them to use a trust structure instead of a look-through company these days. (Practitioner C)

I think the LAQC regime that we had in the past was a little more simple to understand. I never really quite understood the need to go down the LTC path when we had ... You know, I think what is sort of did was it complicated the LAQC regime. (Practitioner H)

However, some practitioners did view the regime as being successful:

No, I think it's actually a pretty good regime. (Practitioner F)

I think it is, for those who have used it for what it should have been used for, and for those who went into it knowing what the consequences were, it would have been successful. I think there would have been an awful lot of companies that became LTCs without appreciating the true consequences, and I think that there's still some aftermath flow-out effects that will come from that. (Practitioner M)

Many practitioners were of the view that a complete repeal of the LAQC/QC regime was unnecessary. Rather, they were of the view that the same results that LTCs had could have been gained from tweaking the LAQC/QC regime rules:

We are now 6 years into the LTC regime, there's more changes coming through, particularly in relation to the owners basis regime, which means the LTC regime looks and smells almost identical to the QC regime, but there are a couple of important differences, but just the whole regime is a waste of time. They could have done it so much better. (Practitioner A)

Absolutely and, in my view, they probably should have done that because they would have then worked off something that everybody understood, and then tweaked it to address the policy concerns. Whereas, what they have done is introduce a completely new regime which means that - and we are talking about sole practitioner accountants who are having to get their heads around stuff like that and there isn't sufficient support for people to get to grips with the new sections, get to grips with the way the new regime is intended to work and I don't believe sufficient support what was given at the time it was introduced in any case. (Practitioner C)

Yeah, I think from a practical perspective they most certainly could have. Obviously from a political perspective, the Government being able to say that we're getting rid of LAQCs. It made it sound like they were ... well, the way the media presented the LAQC situation in the context of ... it's perceived as unfair tax agreement by owners. They could've just tweaked it and I suppose they could have at the end of the day go, "what have we got now?", we've just got an effectively limited partnership regime for companies. (Practitioner B)

Yes. When the budget day announcement of scrapping the QC regime, or scrapping the LAQC regime, was a sledgehammer with a small nut if you like. (Practitioner L)

4.2.8.2 LTC Implementation Process

Practitioners generally viewed the LTC implementation process as being “poor”. Practitioner A provides an example of such a view:

This whole legislative process for introducing the LTC regime was from my view absolutely appalling. They announced it in a budget and it took them a long time to bring out the draft legislation. The draft legislation was absolute rubbish, full of vagaries, and a number of submissions were made to that effect by all sorts of people. And then they came out with an amended bill and gave us like seven days to make submissions or it might have been they did not allow any further submissions, and that amended legislation, or amended draft legislation was still full of holes and had all these uncertainties in it. And then it was passed, much to everyone’s disgust it was passed, and came into law. (Practitioner A)

Practitioners J and L shared this view:

When the LTC regime came in, it was very bad of the government to do this, but they ... This is what happens when you’ve got a third term government, That they sort of abused the parliamentary process and introduced this whole reform through a supplementary order paper, which was not what supplementary order papers are for, and as a result; it wasn’t consulted on particularly widely. So, it wasn’t the best piece of legislation they’d ever drafted and it had a number of errors in it. (Practitioner J)

It was a government directive, and we got an answer, which was much better than what was proposed, but certainly it wasn’t a transparent and robust tax discussion that got us to the regime. The legislation has been ‘crap’. And it still is, so if you look at the history of the loss limitation rule, and you see how many amendments have been made to that since it was introduced, and then you look at the Closely Held Company Bill that’s going to repeal it altogether, and you say, okay, you’ve got a unsophisticated group of taxpayers who should be dealing with reasonably simple stuff, and we’ve got a rule that’s never worked and officials couldn’t make it work, then I think that’s an apparent answer to your question. (Practitioner L)

4.3 Chapter Summary

This chapter introduced the results of semi-structured interviews with practitioners. As a starting point, the researcher sought to understand what a typical use for the LTC structure might be. Practitioners provided varied answers to this question, including for owning rental properties, by companies anticipating losses, for small family businesses, and for international tax structuring and planning. However, some practitioners indicated that LTCs were not useful in some of the scenarios above.

Practitioners also provided various reasons for why the structure is used. The most common reason being the fiscal transparency that the structure provides. A few practitioners viewed this as actually being a disadvantage of the structure. Some practitioners also viewed limited liability as being a reason for use, but again, some practitioners did not view this as being important. Practitioners gave other reasons for its use, 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. Another important reason for the uses mentioned by practitioners was that LTCs were seen as a default replacement for LAQC/QCs.

Practitioners stated that in almost all circumstances, it was they who recommended clients use the LTC structure. Practitioners were also of the view that clients generally had very low levels of knowledge on LTCs. In fact, clients knew more about the LAQCs than LTCs, even though LAQCs have been repealed for over five years. Regarding popularity, practitioners held mixed views. Overall, most practitioners were generally of the view that LTCs were not as popular as LAQCs.

In addition to the advantages covered in reasons for use, some practitioners also stated that the LTC structure had other advantages. These included simplicity, separation and interest deductibility.

Practitioners were of the view that there were a number of disadvantages of LTCs. The most commonly mentioned disadvantage mentioned by practitioners was the loss/deduction limitation rule, and the associated owners' basis test. Almost all practitioners mentioned this.

The next most common disadvantage was the LTC eligibility requirements. Other disadvantages mentioned by practitioners were the inability to quarantine profits or losses, shareholder changes, transparency, and poor and ambiguous legislation.

Another disadvantage mentioned by all but one practitioner was the complexity of LTCs. Practitioners believed LTCs were complex because of the loss/deduction limitation rule and the poor quality of legislative drafting.

Most practitioners believed that LTCs were the most similar to limited partnerships. Practitioners also believed that LTCs were similar to LAQC/QCs, but more complex, primarily because of the loss/deduction limitation rule. Practitioners had mixed views on whether limited partnerships were more complex than LTCs, and whether limited partnerships were substitutes for LTCs. Practitioners were also of the view that LTCs were more complex than traditional structures such as sole traders, partnerships and traditional companies.

Practitioners had varying numbers of QCs that they acted for. Practitioners that acted for QCs stated that they would not advise clients to transition to another structure unless it was necessary. This was due to the advantageous tax rules QCs have, and the possible tax cost of transitioning out of the QC structure into another structure. There was no consensus on what structure practitioners would advise clients with QCs to transition to.

Practitioners considered the advantages of QCs to be the ability to get capital gains out of the company without its liquidation, a lower effective tax rate (due to the ability to quarantine losses or profits within company) and the fact that they are understood easily. The most commonly cited advantage was the ability to extract capital gains. Conversely, practitioners considered the disadvantages of QCs to be the elections required to maintain QC status, and the lack of automatic interest deduction.

All practitioners were aware of the changes that were proposed at the time of the interviews for LTCs. Some practitioners thought the timing of the changes was poor. Most practitioners believed that the changes would make it a better regime. In terms of specific changes, all practitioners who talked about the change to the loss/deduction limitation rule were supportive of the change. However, most practitioners did not support the changes proposed

to tighten the eligibility criteria for LTCs. Whilst not specific to LTCs, all practitioners supported the changes to the tainted capital gains rule. Other practitioners also supported the change to the entry tax, and the continuity test for QCs. Some practitioners believed that the changes to LTCs would result in legal uncertainty for practitioners that were not tax specialists.

Almost all practitioners believed additional changes should have been made to the LTC regime, such as expanding the five counted-owners restriction and clarifying the transparency of the LTC regime.

Overall, most practitioners did not regard the LTC regime as being successful. Many practitioners thought a complete repeal of the LAQC/QC regime was unnecessary. Rather, the same results could have been gained from tweaking the regime. A final point made by some practitioners was that the LTC implementation process was poor. There was very limited consultation, and as a result, poorly drafted legislation was enacted.

Chapter 5: Discussion and Analysis

5.1 Introduction

This chapter discusses and analyses the findings from the semi-structured interviews with tax practitioners. First, the context for which these findings are analysed is discussed. Specifically, the institutions that impact upon closely held tax policy (Parliament, Inland Revenue and tax practitioners collectively) are detailed. Next, the findings are analysed, using historical institutionalism. This is used to provide concluding observations.

5.2 Discussion and Analysis

5.2.1 Institutions

As mentioned earlier in Chapter 3, institutional theory is used as the theoretical framework for this thesis. In relation to closely held company legislation, the institutions of Parliament, Inland Revenue and tax practitioners have all had an impact. Parliament and Inland Revenue are “formal institutions”, whilst tax practitioners are a “social institution”. Each of institutions will be discussed in more detail below.

5.2.2.1 Parliament

New Zealand has a unicameral system⁶ of parliament, which is made up of elected members (MPs) (Webb et al., 2016). The public elects these MPs in general elections via a mixed member proportional system (MMP). Under MMP a coalition government is normally elected (Atkinson, 2003). Parliament is the supreme lawmaker⁷ in New Zealand, and is responsible for passing legislation. Of relevance to closely held company tax policy, it is Parliament that passed closely held company legislation.

⁶ A unicameral parliamentary system is one that has only one legislative chamber. Before 1951 New Zealand's parliamentary system was bicameral, due to the existence of an upper chamber, the New Zealand Legislative Council (Webb, Ruru, & Scott, 2016).

⁷ Parliamentary supremacy is the notion that Parliament is sovereign, and has precedence over the judiciary and the executive (Joseph, 2014).

There are multiple stages before a Bill passes into legislation. These stages are aimed at ensuring that legislation is subject to public debate and scrutiny, and some stages provide an opportunity for the Bill to be changed (New Zealand Parliament, 2017). These stages are:

- Introduction
- First reading
- Select Committee
- Second reading
- Committee of the Whole House
- Third reading
- Royal assent

Appendix 3 provides a diagram of these stages and how they interact with each other.

At the time of writing, and since 2008, the National Party has governed New Zealand in coalition with other parties. Prior to that, government alternated between Labour-led and National-led Governments. MMP has been used since 1993, and before this a first-past-the-post (FPP) system was used (Webb et al., 2016). The current Prime Minister of New Zealand is the Rt Hon Bill English, and the Minister of Finance is the Hon Steven Joyce (Department of the Prime Minister and Cabinet, 2017). The Minister responsible for Inland Revenue (discussed in 5.2.1.2) is the Hon Judith Collins (Department of the Prime Minister and Cabinet, 2017).

5.2.2.2 Inland Revenue

Inland Revenue is tasked with the administration of tax legislation in New Zealand. This involves advising the Government on tax policy, and collecting tax (Inland Revenue Department, 2016a). Additionally, Inland Revenue also collects and disburses payments for social support programmes such as Working for Families (Inland Revenue Department, 2016a). In regard to closely held companies, Inland Revenue collects tax paid by these entities, but more importantly, advises the Government on related tax policy.

Inland Revenue is currently structured into nine business groups (Inland Revenue Department, 2016a). These are:

- Service Delivery
- Technology Strategy and Operations
- Change; Performance, Facilities and Finance
- People and Culture
- Chief Office of the Tax Counsel
- Corporate Integrity and Assurance
- Information, Intelligence and Communications
- Policy and Strategy

The most relevant business group to closely held company legislation is Policy and Strategy. Alongside advising the Government on the related tax policy, the Policy and Strategy group drafts tax legislation, forecasts tax revenues and maintains double-tax agreements (Inland Revenue Department, 2017). An individual that sits on the executive leadership team heads each of these groups. Currently, the Commissioner and Chief Executive of Inland Revenue is Naomi Ferguson.

5.2.2.3 Tax Practitioners

Tax practitioners in New Zealand also impact tax policy outcomes through submissions. When new or changed tax legislation is proposed, the GTPP process requests submissions from tax practitioners (Sawyer, 2013b). Notably, this process was omitted during the original implementation of the LTC regime. Through this process, tax practitioners are able to provide feedback and recommendations on any proposed changes. This generally results in better tax policy being developed. Thus, tax practitioners have a considerable impact upon closely held company tax policy in New Zealand. Perhaps most importantly, tax practitioners must apply tax legislation in New Zealand, resulting in practical insights from this group.

As mentioned in section 2.8.1, there is no statutory regulation on who can be a tax practitioner in New Zealand. This means that tax practitioners in New Zealand are a diverse body. In terms of submissions, groups that have the most weight are Chartered Accountants

Australia and New Zealand (CAANZ), New Zealand Law Society (NZLS), and the Big 4 accounting firms (PriceWaterhouse Coopers, KPMG, Ernst and Young, and Deloitte). In addition to this, submissions from large law firms such as Belly Gully, Russell McVeagh, and Chapman Tripp are also influential.

5.2.2 Policy Rationale

The predecessor to LTCs, the QC/LAQC, was introduced after recommendations from The Consultative Committee on the Reform of the Taxation of Income from Capital (The Valabh Committee) (1990). The Valabh Committee was a committee appointed by Parliament, and were tasked with reviewing various aspects of the income tax system (Inland Revenue Department, 2010). One recommendation that was accepted by Parliament was the implementation of the QC regime. QCs were 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; and
- Minimised complexity.

The QC/LAQC regime was only open to companies with five or fewer shareholders, with shareholders being related by blood or marriage counting as one shareholder (Inland Revenue Department, 1991). Thus, due to the nature of the regime, it is apparent that it was targeted towards smaller, family owned businesses. This same restriction on owners was retained for the LTC regime, as this regime was considered a replacement for the QC/LAQC regime (Inland Revenue Department, 2015b). Notably, the LTC regime relaxed requirements around who was counted as one shareholder, resulting in a structure that was able to be used in more circumstances (Inland Revenue Department, 2014).

The LAQC (which allowed flow-through of losses) was initially rejected by the Valabh Committee due to fears that different classes of shares would make attributions complicated and impractical (Consultative Committee on the Reform of the Taxation of Income from Capital, 1990). Submissions from tax practitioners forced a reconsideration from Parliament.

The Valabh Committee stated that the resultant change was because the pass through of losses would help achieve one of its objectives, namely, closer integration between taxation of the company and its shareholders (Consultative Committee on the Reform of the Taxation of Income from Capital, 1990).

The QC/LAQC regime was superseded by the LTC regime from the financial year beginning 1 April 2011. Parliament and Inland Revenue's intention was that LTCs were to replace QC/LAQCs (Inland Revenue Department, 2015b). The exact reasons given for the repeal of QC/LAQCs are unclear, but it appears that it was a politically driven change. Concerns were expressed about the use of LAQCs for property speculation (Inland Revenue Department, 2010), and the National-led Government at the time responded by repealing the regime all together. As previously mentioned, tax practitioners were not consulted on the repeal. The Labour-led Opposition at the time drew attention to this limited consultation, especially due to the large number of taxpayers impacted by the repeal (Nash, 2010). Regarding institutional theory, this may be viewed as a critical juncture; a rapid change from a set policy path (Peters et al., 2005).

Existing QCs were permitted to continue. Inland Revenue has stated this was due to 'stakeholder concerns' at the time (Inland Revenue Department, 2015b). Recently, Inland Revenue has stated that it would be unrealistic to expect all QCs to transfer into the LTC regime, as it would not suit every QC (Inland Revenue Department, 2015b). Instead, Inland Revenue proposed a QC continuity rule, effectively preventing 'QC trading', and this recommendation was accepted by Parliament in the most recent round of amendments, and became law from the 2017/18 tax year.

One major difference between QC/LAQCs and LTCs is the loss/deduction limitation rule, which was implemented with the enactment of LTCs. This was due to concerns around losses being deducted when shareholders had no financial interest in LTCs (Inland Revenue Department, 2011a). However, Inland Revenue has since stated that this rule was too broad, and resulted in unnecessary compliance costs (Inland Revenue Department, 2015b). This loss/deduction limitation rule has been narrowed from the 2017/18 tax year, and is now only relevant to LTCs in partnership or joint venture (Inland Revenue Department, 2016b). These changes, alongside others made at the same time, were aimed at eliminating the issues with

LTCs. The Regulatory Impact Statement (Inland Revenue Department, 2015b) has grouped these issues into three main groups. These are as follows:

1. Rules which impose unnecessary compliance costs
2. Rules which restrict commercial practice
3. Rules which fail to achieve their intended policy objectives

5.2.3 Analysis of Interviews with Tax Practitioners

The intended target market of LTCs was small family businesses. Whilst some practitioners indicated that small family businesses were a use of 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. However, uses such as rental properties, companies anticipating losses, and international tax structuring and planning, utilise the LTC structure solely for its taxation characteristics.

Practitioners also indicated that it was they who recommended clients use the LTC structure, and that clients had very low levels of understanding surrounding LTCs. 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 of LAQCs, even though they have been repealed for over five years. This is likely to be due to the level of media coverage surrounding the use of the LAQC 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.

Most practitioners were of the view that LTCs were not popular overall. An Official Information Act (OIA) request by the author revealed that there were 45,883 LTC tax returns filed in 2016, compared with 152,000 LAQC returns in 2010. Table 5.1 provides a full

breakdown of the number of closely-held company tax returns (QCs, LAQCs, and LTCs) filed each tax year, alongside the total losses distributed through each structure. Limited partnerships are also included as they also provide fiscal transparency, and were introduced only three years prior to LTCs. These figures indicate that LTCs are not as popular as LAQCs were before their repeal. Notably, there were 51,755 QC returns filed in 2016, which is more than LTC regimes. Thus, LTCs are not as popular as LAQCs, or even QCs. However, the LAQC regime had been around for a much longer time than LTCs, possibly skewing this finding. Regardless, the uptake of LTCs has proven to be lower than expected; Parliament had expected that almost all LAQCs would transition to LTCs (Inland Revenue Department, 2016b). Whilst some tax practitioners viewed LTCs as default replacement for LAQC/QCs, many practitioners did not view the regime as being a replacement.

Whilst LAQCs have been abolished, existing QCs have been permitted to continue. It appears that Inland Revenue hoped that the majority of QCs would elect into the LTC regime, and the QC would slowly fall out of use. As mentioned previously, there were 51,755 QCs in existence at the end of the 2016 tax year, compared with 75,582 in 2011. This is a marked decline; however, there is still a considerable number of QCs in existence. Practitioners stated that they had varying numbers of QCs that they acted for. One practitioner had almost 250 QCs that they acted for, whilst another practitioner had none. Practitioners were of the view that it was not advantageous for QCs to transition to another structure, regardless of what it was. This is due to tax advantages QCs have, which is again contrary to the original policy intention stated by Parliament of 'leveling the playing field'. Additionally, a transition to another structure would now result in a tax cost, due to the expiration of concessionary rules. This is in conflict with the idea of closely held companies reducing compliance costs. However, it is likely that at some stage, existing QCs will need to transition to another structure, following a wider review of dividend rules (Inland Revenue Department, 2016b). Whether Inland Revenue will suggest further transitional concessions is unclear.

Table 5.1: Closely Held Company Tax Returns

LAQC Returns Filed & Filed Losses for Tax Years 1997 – 2010		
Year	Number of Returns filed	Total Losses (\$ million)
1997	32,800	\$316
1998	37,200	\$365
1999	41,900	\$404
2000	47,200	\$448
2001	53,400	\$568
2002	60,700	\$627
2003	72,300	\$795
2004	88,500	\$979
2005	104,100	\$1,256
2006	119,400	\$1,649
2007	134,400	\$1,991
2008	146,200	\$2,433
2009	150,200	\$3,209
2010	152,000	\$2,490

LTC Returns Filed & Total Losses for Tax Years 2012 – 2015		
Year	Number of Returns filed	Total Losses (\$ million)
2012	42,591	\$725
2013	46,218	\$664
2014	46,919	\$603
2015	46,855	\$607
2016	45,882	\$624
QC Returns for Tax Years 2011 – 2015		
Year	Number of Returns filed	
2011	75,582	
2012	70,566	
2013	65,826	
2014	62,173	
2015	57,852	
2016	51,755	

LP Returns Filed & Total Losses for Tax Years 2009 – 2015		
Year	Number of Returns filed	Total Losses (\$ million)
2009	113	\$17
2010	334	\$45
2011	648	\$75
2012	995	\$132
2013	1,194	\$221
2014	1,361	\$148
2015	1,507	\$238
2016	1,685	\$320

Source: Official Information Act Request by the author.

Practitioners also provided various reasons for why the LTC structure is used. The most common reason given for using the structure was the fiscal transparency that the structure provides. As mentioned before, this fiscal transparency originally arose due to submissions from tax practitioners themselves. There was no consensus from practitioners on whether limited liability was important in deciding whether to use or recommend an LTC. Notably, only limited partnerships offer limited liability and tax flow-through treatment, alongside LTCs. Practitioners gave other reasons for LTC use, 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. Importantly, if the LTC structure was truly aimed at eliminating the role taxation plays in the choice of business entity, then many of these advantages would not exist.

In addition to the advantages discussed above, practitioners also stated that the LTC structure had other benefits. These included simplicity, separation and interest deductibility. The perceived advantage of simplicity aligns with the policy rationale (as stated by Parliament) 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 LTCs were 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.

Practitioners were of the view that there were a number of disadvantages of LTCs. The most commonly mentioned disadvantage was the loss/deduction limitation rule and the associated owners' basis test. This resulted in unnecessary complexity, and thus compliance costs. This is discussed further in 5.2.2.4. 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 required⁸ for a closely held company regime.

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 (Consultative Committee on the Reform of the Taxation of Income from Capital, 1990; Inland Revenue Department, 1991). Due to LTCs being the successor to QC/LAQCs, that simplification of taxation is also a policy intention for LTCs (Inland Revenue Department, 2015b). However, the majority of practitioners were of the view that LTCs were 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. Thus, all practitioners supported the narrowing of the scope of the loss/deduction limitation rule.

The other reason practitioners believe LTCs are complex is because of poor quality legislative drafting. This has also been recognised by Inland Revenue, who drafted the legislation, as there have been a multitude of amendments to the LTC legislation since enactment. However, many of these amendments have been practitioner instigated through submissions and consultation with Inland Revenue. Notably, some practitioners were of the

⁸ The Income Tax Act 2007 defines a closely held company as being a company to which one of the following applies:

(a) at the time there are 5 or fewer persons, the total of whose direct voting interests in the company is more than 50%, treating all persons associated at the time as 1 person; or
(b) at the time:
(i) a market value circumstance exists for the company; and
(ii) there are 5 or fewer persons, the total of whose direct market value interests in the company is more than 50%, treating all persons associated at the time as 1 person.

view that this low quality legislation was a direct result of Parliament implementing the LTC regime through Supplementary Order Paper 187. This occurred at 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 (Vial, 2012).

As mentioned previously, one of the original aims of the QC/LAQC regime, and thus the LTC regime, was to eliminate the role taxation played in the choice of business entity. Thus, LTCs would be comparable to structures such as sole traders, partnerships and traditional companies. Practitioners indicated that this was not so, and in fact LTCs were much more complex than these other structures. In addition to this, eliminating taxation's role in the choice of business entity would mean that LTCs would not provide significant tax advantages or disadvantages over these traditional structures. Most practitioners were of the view that LTCs were the most similar to limited partnerships. However, whilst LTCs are targeted towards small family businesses, limited partnerships are instead geared towards foreign investment and venture capital (Inland Revenue Department, 2006; Plunket & Wells, 2008). Thus, due to the differences in target audiences, these regimes should in fact be dissimilar to a large degree. Practitioners had mixed views on whether limited partnerships were more complex than LTCs, but given the target audiences, LTC rules should be simpler and easier to apply.

Practitioners considered the advantages of QCs to be the ability to distribute capital gains out of the company without liquidation, a lower tax rate,⁹ and the idea that they are understood easily. The ability to distribute capital gains out of the entity is also present in LTCs, however the ability to quarantine losses or profits within the company is not. This means that all profits or losses must flow out to the shareholders, possibly meaning QCs have a lower effective tax rate. Some practitioners mentioned this as being an unfair advantage, and this has been noted in the Official's Report as being an action point for the future (Finance and Expenditure Committee, 2016a). However, practitioners stated that QCs had disadvantages

⁹ Because QCs have the ability to quarantine losses or profits within the company, this may result in a lower tax rate. The company tax rate is 28% and the highest individual tax rate is 33%.

that other structures did not have, and this included the shareholder elections and maintaining QC status,¹⁰ as well as a lack of automatic interest deduction.¹¹

Most practitioners believed that additional changes should be made to the LTC regime. A commonly mentioned change was the broadening of the five counted-owners restriction. However, the five counted-owners restriction is broader than the restrictions placed upon the owners of QC/LAQCs. Additionally, expanding the five counted-owners restriction is contrary to the policy rationale stated by Parliament for LTCs. Since LTCs are targeted at small family businesses, this restriction should not have any impact on who uses an LTC. Another change suggested by practitioners was clarifying the transparency of the LTC regime. Inland Revenue has recognised this as an area that needs more work; however the exact timeframe around this is unclear (Inland Revenue Department, 2016b).

5.3 Chapter Summary

This chapter provided analysis of the findings gathered from documentary analysis and from interviews with tax practitioners. Historical institutionalism was used, as it is able to provide insights into the key explanatory variables in the tax policy process. In regard to closely held company legislation, relevant institutions are Parliament and Inland Revenue, which are formal institutions. These groups have a defined structure and hierarchy. Another relevant institution is tax practitioners collectively, who are a social institution. Due to the lack of formal requirements on who can be a tax practitioner in New Zealand, this is a dynamic group. Each of these groups (Parliament, Inland Revenue and tax practitioners) has had an impact on closely held company legislation, each to varying degrees.

In regard to the policy rationale for closely held regimes, the predecessor to the LTC, the QC/LAQC was introduced at the recommendation of the Valabh Committee. It was aimed at reducing the role taxation played in the choice of business entity, achieving greater integration between company and individual taxation, and minimising complexity. LAQCs were not originally permitted, but submissions from tax practitioners changed this. These

¹⁰ For a QC to remain a QC, it needs to meet the requirements under s HA5 to s HA9 for the entire income year. If the QC loses its status, s HA11 will apply.

¹¹ Under s DB7, most companies are allowed to deduct interest regardless of a nexus with income, however this does not apply to QCs.

entities are targeted towards small family businesses. The QC/LAQC regime was superseded by the LTC regime from the financial years beginning 1 April 2011. Parliament and Inland Revenue's intention was that LTCs were to replace QC/LAQCs (Inland Revenue Department, 2015b). The exact reasons given for the repeal of QC/LAQCs are unclear, but it appears that it was a politically driven change. Due to the similar target market of these regimes, the stated policy intention of QC/LAQCs and LTCs is almost identical (Inland Revenue Department, 2016b). LTCs were intended to replace QC/LAQCs but their uptake has been slower than expected by Parliament.

When comparing the policy rationale against tax practitioners' perspectives, there appears to be considerable divergence. One of these areas of divergence is the use of LTCs. The intended use of the regime was for small family businesses, and whilst practitioners did view that as being one use, there were multiple other perceived uses such as owning rental properties, by companies anticipating losses, and for international tax structuring and planning. In fact, small family businesses generally have low levels of knowledge on LTCs.

The policy rationale for LTCs also indicates that there should be minimal advantages from the use of the structure, especially in comparison to other structures. The main advantage stated by tax practitioners was fiscal transparency, which is also available with partnerships and limited partnerships. Other advantages stated did not appear to be contemplated by Parliament in enacting LTCs, and these include minimising double taxation, tax-free distributions to shareholders, and minimising tax on historic retained earnings. As well as this, tax practitioners mentioned simplicity, separation and interest deductibility as being an advantage. Whilst simplicity is one policy intention, separation and interest deductibility is not. However, this can be achieved through other structures that are not LTCs.¹²

As with the advantages of LTCs, the majority of disadvantages did not also seem to be contemplated by Parliament. These included the loss/deduction limitation rule, and associated owner's basis test, which resulting in unnecessary compliance costs. Again, this is contrary to the policy rationale behind LTCs. This has been recognised by Inland Revenue and Parliament, as the scope of this rule has now been narrowed. Another disadvantage stated by practitioners was the limitation on owners, but this is necessary for the regime to be targeted

¹² For example, the same interest deductibility benefits can be gained using a traditional company.

towards small family businesses. Complexity was also viewed as a disadvantage, which primarily arises from the loss/deduction limitation rule and poorly drafted legislation. Inland Revenue and Parliament have since remedied the loss/deduction limitation rule by limiting its scope. Poorly drafted legislation has also been subject to numerous fixes and changes, however the complexity arising from this is not completely eliminated.

LTCs were intended to be similar to other structures that small family businesses might use, such as sole traders, partnerships and traditional companies. However, practitioners have indicated that this is not the case. In fact, the most similar structure to an LTC is largely considered to be a limited partnership, a regime targeted towards sophisticated, international investors.

In regard to QCs, the majority of advantages did not appear to be contemplated by Parliament. However, there are a number of disadvantages that appear to balance these out. One main disadvantage is that no new QCs can be formed. There are still a considerable number in existence, and removing these would create a “level playing field”. This has been noted in the Official’s Report as being an action point for the future (Finance and Expenditure Committee, 2016a).

Chapter 6: Conclusions, Limitations and Future Research

6.1 Conclusions

The aim of this study was to explore look-through companies (LTCs) from a tax practitioner's perspective. Specifically, LTCs were compared with their predecessor, loss-attributing qualifying companies (LAQCs), in order to evaluate the efficacy of New Zealand's closely held company regimes. Thus, the broad research questions that this thesis answered were as follows:

RQ 1: What types of businesses typically use the LTC regime?

RQ 2: Based on their experience dealing with clients, do tax practitioners believe that the LTC regime has reduced compliance costs compared with QC/LAQCs, as well as compared with other structures?

RQ 3: To what extent do tax practitioners recommend the adoption of the LTC regime to clients?

RQ 4: Overall, what is the primary reason (or motivation) for clients to utilise the LTC regime?

RQ 5: Do tax practitioners believe the changes to the LTC regime will decrease compliance costs? Why or why not?

Regarding the first question, the findings indicated that a range of businesses use the LTC regime. Practitioners did not have a consensus on what a typical use may look like, and indicated that LTCs were used for rental properties, companies anticipating losses, small family businesses and for international tax structuring and planning. Whilst Inland Revenue and Parliament contemplated the use of the LTC regime for small family businesses in enacting the regime, the other uses were not intended. In fact, most of the other uses are directly in conflict with the rationale for the regime, being to eliminate the role tax plays in choice of entity, achieving closer integration between the company and its shareholders, and reducing complexity.

Based on their experience, practitioners were generally of the view that the LTC regime resulted in higher compliance costs, especially when compared to QC/LAQCs. Additionally, practitioners were also of the view that the LTC regime resulted in higher compliance costs when compared to traditional structures such as sole traders, partnerships, and companies. These higher compliance costs arise due to LTCs being more complex than these other structures. Practitioners stated that this complexity was due to two main reasons: the loss/deduction limitation rule (and owners-basis test) and poorly drafted legislation. As previously mentioned, reducing complexity was an original aim of special closely held company regimes. However, when considering these findings, it appears the opposite has occurred.

This complexity was one of the reasons that practitioners did not generally recommend the LTC regime to clients. However, if clients did use the LTC regime, it was almost always at the recommendation of practitioners. Clients tended to have very low levels of knowledge of LTCs, and often knew more about LAQCs, which have been repealed for a number of years. Figures released under the Official Information Act indicated that LTCs have not been as popular as their predecessor, LAQCs. In the last year that LAQCs were in existence, there were 152,000 tax returns filed. This compares to 45,883 LTC returns being filed in 2016.

In regard to the rationale or motivation behind using LTCs, there was no consensus amongst practitioners. The most common reason for using the structure was the fiscal transparency that the structure provides. Some practitioners also viewed limited liability as being a reason for use. In addition, LTCs were also used to minimise double taxation, allow tax-free distributions to shareholders, and minimise tax on historic retained earnings. Another important reason for the use of LTCs mentioned by practitioners was that they were seen as a default replacement for LAQC/QCs and as such, many chose to transition into the regime. However, this is also contrary to the policy rationale for the regime; reducing the role that taxation plays in the choice of the entity.

Finally, practitioners were generally of the view that the most recent round of changes would decrease compliance costs for those that used the LTC regime. All practitioners were supportive of the removal of the loss/deduction rule, which, as previously mentioned, is a leading contributor to the regime's complexity. However, a number of practitioners believed

that other changes should have been made to the regime. These included expanding the five counted-owners restriction, and clarifying the transparency of the LTC regime.

Though not directly addressed by the research questions, a number of other findings emerged from this research. One of these related to QCs that have not transitioned to another form such as LTCs. Whilst no new QCs can be formed, existing QCs have advantageous tax treatment over other structures. This includes a lower tax rate than LTCs, and the ability to quarantine profits and losses. This has been recognised by Inland Revenue, and provisions have been introduced to prevent ‘QC trading’. However, existing QCs are not dealt with by the latest amendments and at the end of the 2016 tax year, there were still 51,755 in existence.

Another finding is that most practitioners did not regard the LTC regime as being successful. Many practitioners thought a complete repeal of the LAQC/QC regime was unnecessary, and it was viewed as “using a sledgehammer to crack a nut”. Rather, practitioners believed the same results could have been gained from tweaking the existing LAQC/QC regime. Another point made by some practitioners was that the LTC implementation process was poor. There was very limited consultation, and as a result, poor quality legislation was drafted.

6.2 Recommendations

This insights provided by this thesis allow a number of recommendations to be made to policy-makers. Firstly, the importance of consultation during the legislative process was highlighted. It is apparent that the lack of consultation prior to the enactment of the LTC regime led to poor quality legislation being drafted. Thus, it is recommended that the full GTTP process, as shown in Appendix 4, be followed when new tax policy is to be enacted, especially when the tax policy changes impacts upon a substantial number of taxpayers.

Secondly, this thesis highlights the importance of educating those impacted upon by tax policy changes. Some tax practitioners mentioned that there was little education, and as shown by the implementation of New Zealand’s GST regime, education is an important factor in determining whether changes will be effective (Sawyer, 2013a).

Finally, it is recommended that policy-makers do more work in regard to LTC legislation. Whilst practitioners view the removal of the loss/deduction limitation rule as being positive, there is still confusion about how transparent the structure is. Additionally, there is still over 50,000 QCs in existence, which provide unfair tax advantages to those able to utilise this structure. Thus, it is recommended that the QC rules are overhauled at the same time clarifications are made to the LTC legislation.

6.3 Contributions to Knowledge

This thesis has contributed to knowledge in a number of ways. First, it contributes to the limited body of knowledge of closely held companies. To the author's knowledge, this is the first piece of empirical research conducted on LTCs. Furthermore, there has also been limited research on QC/LAQCs, with no empirical research published to date.

Furthermore, this research also contributes to the body of knowledge as it provides a critical perspective, namely that of the tax practitioner. Additionally, the use of institutional theory provides insights into the tax policy surrounding closely held companies.

Finally, this research may be of interest to tax policy-makers, as it has provided insight into the efficacy of closely held company legislation in New Zealand. Such insights may be useful for policy-makers when considering further changes and amendments to closely held company legislation. Additionally, this research highlights the advantages of consultation via the GTTP.

6.4 Limitations

6.4.1 Scope of Research

One limitation of this research was its scope. This research forms the basis of a thesis submitted in part fulfilment for the requirements of a Master of Commerce. 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. For example, limited partnerships were discussed in the

interviews, but due to the scope of this research, they were not included. The perceived role of tax practitioners in the overall tax system was also discussed with interviewees, but not included in this thesis.

6.4.2 Legislative Environment

The legislative changes to the look-through company regime presented challenges to this research. Interviews were conducted before the latest round of changes were enacted and implemented, and as such, the researcher was not able to examine the efficacy of the changes. In addition to this, the amendments were not fully finalised at the time of the interviews, meaning that the changes implemented now may have differed to those proposed, as discussed with the interviewees. However, this also provides a basis for future follow-up research.

6.4.3 Theoretical Framework

Another limitation results from the theoretical framework used, namely historical institutionalism. Historical institutionalism does not effectively explain change within institutions (Peters, 1999; Oats, 2012). This means that the institutions examined (Parliament, Inland Revenue and tax practitioners collectively) were treated as being static, unchanging institutions. In reality, these groups have all undergone changes; especially tax practitioners, who are an amorphous collection of individuals and entities.

6.5 Future Research

Several areas for future research have been identified from this thesis. First, this research has not included interviews with the Inland Revenue Department (IRD). Whilst some of the views of the IRD have been considered through policy documents, interviews with officials and individuals within IRD may have provided additional insights.

Secondly, further research would provide an opportunity to evaluate the LTC regime after the most recent changes came into force. This would assess the effectiveness of the changes, and whether they have actually reduced compliance costs for those that use the regime. This could be done with follow-up interviews with the original interviewees.

Another avenue for future research may be a comparison of fiscally transparent entities in other jurisdictions. One jurisdiction is the United States, which has a tax flow-through entity called the S corporation. Additionally, other OECD nations and their respective tax flow-through entities could be compared. This may result in interesting insights, and perhaps guide future policy changes to LTCs in New Zealand.

Some further questions are listed below regarding LPs that exceeded the scope of this research, but were asked to gather data for future research projects.

1. What scenarios do tax practitioners believe LPs are designed for, relative to LTCs and their predecessors, QC/LAQCs?
2. What types of businesses typically use the LP regime? What is their motivation?
3. To what extent do tax practitioners recommend adoption of the LP regime to clients?
4. If a client does adopt a LTC (or a LP) structure for tax purposes, is this due to a tax practitioners' recommendation? Or is it instigated by the client themselves?
5. What do tax practitioners view their role as being within the tax system?

These could be expanded on for future research.

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Appendices

Appendix 1: University of Canterbury HEC Approval Letter



HUMAN ETHICS COMMITTEE

Secretary, Rebecca Robinson
Telephone: +64 03 364 2987, Extn 45588
Email: human-ethics@canterbury.ac.nz

Ref: HEC 2016/93

9 September 2016

Harry Waddell
Department of Accounting and Information Systems
UNIVERSITY OF CANTERBURY

Dear Harry

The Human Ethics Committee advises that your research proposal “New Zealand's Look-through Company Regime: a Tax Practitioner's Perspective” has been considered and approved.

Please note that this approval is subject to the incorporation of the amendments you have provided in your email of 6th September 2016.

Best wishes for your project.

Yours sincerely

R. Robinson
pp.

Kelly Dombroski
Deputy Chair
University of Canterbury Human Ethics Committee

Appendix 2: Semi-structured Interview Guide

Interviewee Information

How big is your organisation? By partners, and by clients?

What is your role in your organisation?

How long have you been there?

LTCs

What types of (client) businesses use the LTC regime? Family businesses? Rental properties? Other?

Why, in your view, do these businesses use the LTC structure?

What are the advantages/drawbacks of the LTC structure?

At whose recommendation is the structure adopted? (You, your client, referrals?)

Would you consider the LTC regime to be a 'popular' option as a business structure?

What about QCs (yet to transition)? Do you have many clients that use this structure? What structure do you think they will transition to?

What are the advantages/drawbacks of the QC structure?

What business structure would you consider to be the most similar to LTCs? Why?

How complex is the LTC regime? Compared to QC/LAQCS? Compared to LP's? Compared to sole traders, partnerships, 'traditional' companies?

If LTCs are complex – what causes this complexity?

Are there any specific issues with the LTC regime? Loss limitation rule, winding up (tainted capital gains)?

Are you aware of the upcoming amendments to LTCs? What do you think of these changes?

Main changes:

- Removal of loss limitation rule – only applies to LTCs in partnership or joint venture
- Allowing multiple classes of shares
- Limiting the tainted capital gains rule (only applies to asset sales to companies with 85% common ownership)

Will these changes improve the regime? Or increase uncertainty?

Are there any other changes that should be made?

What is your overall impression of the LTC regime? The QC/LAQC regime (in comparison)?

Other

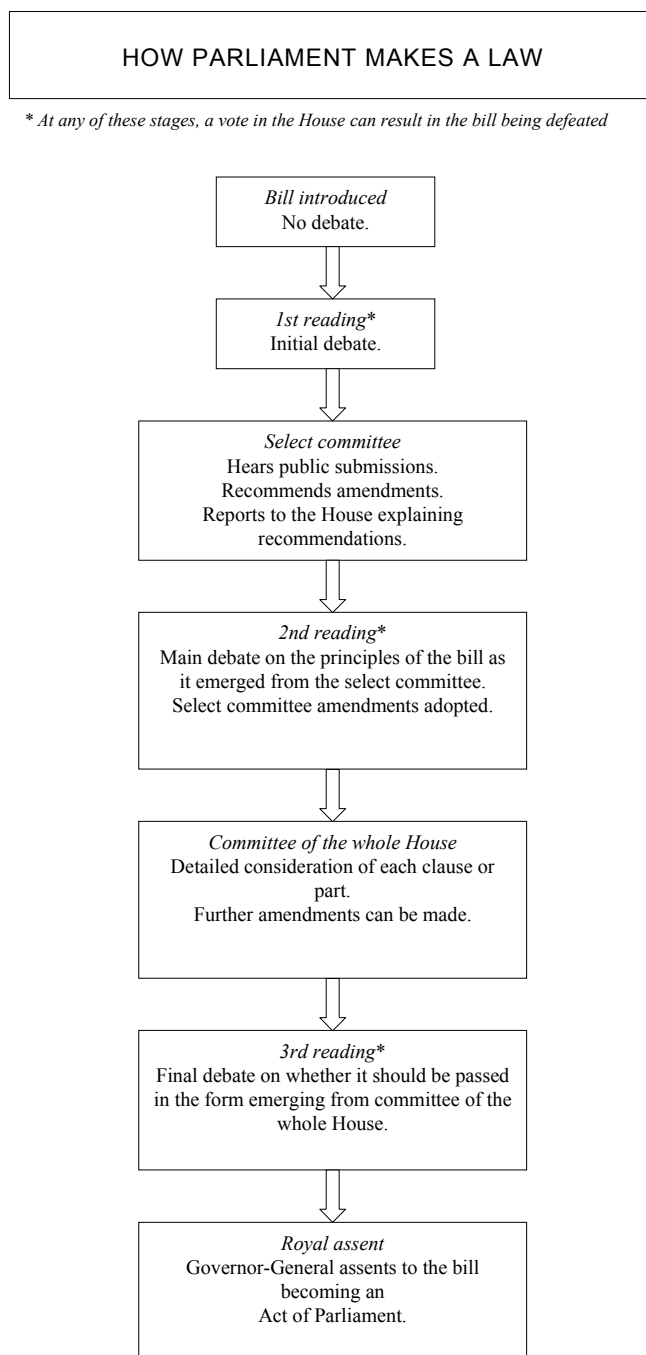
What do you, as a tax practitioner, view your role as within the tax system? If need to elaborate: enforcer for IRD, client advocate, other?)

What businesses, in your view, use the LP regime? Why?

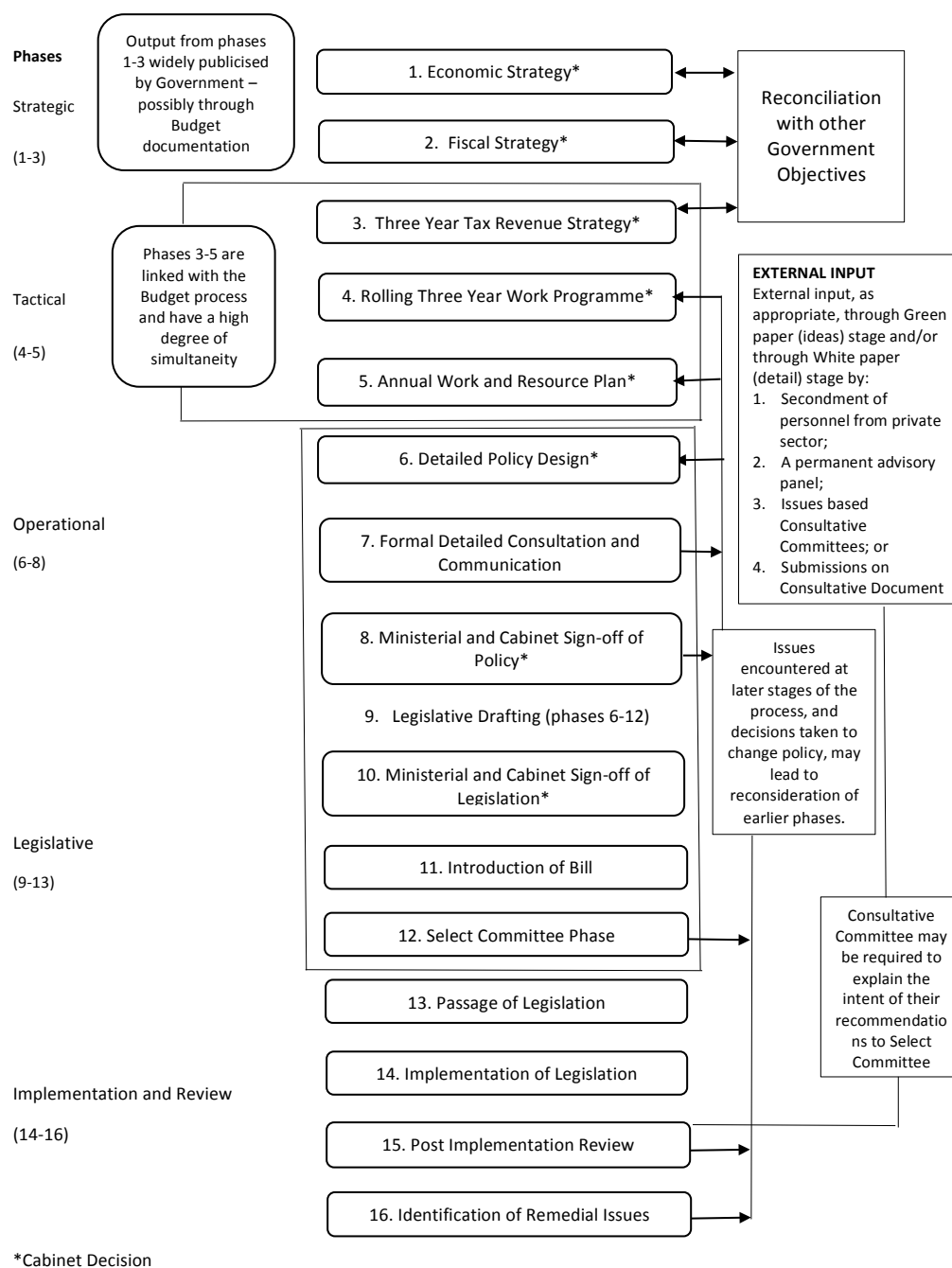
Would you view the LP regime as a substitute for the LTC regime?

If there anything else you would like to add/discuss?

Appendix 3: Legislative Process



Appendix 4: Generic Tax Policy Process (GTPP)



Source: Organisational Review Committee (1994).