December 2010

Fact sheet – Changes to the qualifying company rules

The Government announced in Budget 2010 that the qualifying company rules would be amended. A new transparent form of tax treatment would be introduced to ensure that shareholders who use a company's losses also pay tax on any company profit at their marginal tax rate.

The changes introduced today:

- change the tax treatment of loss attributing qualifying companies (LAQCs) so shareholders can no longer claim losses against their personal income. This will prevent these shareholders being able to claim losses at their higher marginal tax rate and profits at the company tax rate;
- allow existing qualifying companies (QCs) and LAQCs to continue to use the current rules without the ability to attribute losses, pending a review of the dividend rules for closely held companies;
- provide look-through income tax treatment for electing closely-held companies.
- allow QCs and LAQCs to transition into a new look-through company (LTC) vehicle or change to another business vehicle such as a partnership, without a tax cost during the period 1 April 2011 to 31 March 2013.

Look-through companies

What does "look-through" mean?

- "Look-through" effectively means that we ignore the company, which is the legal entity carrying on a business, and tax its shareholders on the company's profits instead. It also means that shareholders can use a company's losses against their other income, subject to the loss limitation rule.
- Look-through treatment applies for income tax purposes only. An LTC retains its corporate obligations and benefits, such as limited liability, under general company law.
- An LTC's income, expenses, tax credits, rebates, gains and losses are passed on to its owners. These items are allocated to each person in proportion to the number of shares they have in the LTC.

- The income of an LTC is taxed and expenses are deducted as if each owner had received that income and incurred the expenses personally. Any profit is taxed at the owner's marginal tax rate. The owner can use any losses against their other income, subject to the loss limitation rule.

- The LTC loss limitation rule is similar to that for limited partnerships. This means owners can offset tax losses only to the extent the losses reflect their economic loss. Any loss that cannot be used is carried forward and may be claimed in future years, subject to the application of the loss limitation rule in those years. There are certain rules about the use of these losses if the LTC ceases to be an LTC, or if the owner sells their shares.

- An LTC is still recognised separately from its shareholders for certain other tax purposes, including GST, PAYE, and certain administrative or other withholding tax purposes under the Income Tax Act.

What sort of company can use the LTC rules?

- The rules are designed for closely held companies which are resident in New Zealand.

- An LTC must have five or fewer "look-through counted owners". Related shareholders may be treated as a single owner for the purposes of this test – for example, if a mother and daughter both hold shares in an LTC they are treated as "one" owner. There are special rules for determining who counts as an owner when shares are held by trustees.

- Only a natural person, trustee or another LTC may hold shares in an LTC. All the company's shares must be of the same class and provide the same rights and obligations to each shareholder.

How does a company become an LTC?

- All owners must elect for a closely held company to become an LTC. Once a company becomes an LTC it will remain in the LTC rules unless one of the owners decides to opt out, or if it ceases to be eligible – for example, by having more than five counted owners.

- LTC election forms will be available early next year from Inland Revenue. In the interim companies can elect just by writing to Inland Revenue with details and signatures from all their shareholders, and details of the shareholding of each.

- Elections should be received before the start of the income year to which they apply. However for the next two income years (starting from 1 April 2011), existing QCs and LAQCs have a six-month extension period to decide whether to transition to the LTC rules (see "**Existing QCs and LAQCs**" below).

What happens when an owner sells their shares in the LTC?

- Owners of an LTC are treated as holding LTC property directly, in proportion to their shareholding. When owners sell their shares they are treated as disposing of their share of the underlying LTC property. If this includes, for example, revenue account property or recovery of depreciation, the shareholder may have to pay any tax associated with the disposal. Tax will only be due if the disposal amounts are above certain thresholds.

- If the company stops using the LTC rules or if the company ceases to exist there will be a deemed disposal and acquisition of the company's property at market value. This may mean the shareholders have to pay tax on any income arising from the deemed disposal.

Existing QCs and LAQCs

Existing QCs and LAQCs have several options to choose from in one of the first two income years starting on or after 1 April 2011; the year they choose is called the "transitional year". These rules apply only to companies that are already QCs or LAQCs in the 2010–11 income year.

They can continue to use the QC rules. Or if they choose to leave the QC rules, they can have a smooth transition into the LTC rules or they can choose to change their business structure into a partnership, limited partnership or a sole trade, with no tax cost.

The QC or LAQC can:

- Continue as a QC, without the ability to attribute losses. The QC rules are otherwise unchanged.
  - This will be the "default" option for all existing QCs and LAQCs.
  - An LAQC will no longer be able to attribute losses to shareholders.
  - Income will be taxed at the company level, and only dividends with imputation credits attached will be taxable to shareholders.
  - Capital gains can be distributed tax-free without winding up the company.

- Choose to be taxed as an ordinary company.
  - The QC or LAQC election must be revoked.
  - Any losses must be used by the company, not the shareholders.
  - All dividends will be taxable to shareholders, although imputation credits may be attached.

- Choose to be taxed as a look-through company (LTC).
  - Existing QCs and LAQCs have six months from the start of their transitional year to elect to become an LTC.
  - Look-through treatment will apply from the start of the transitional year.

- Transition to become a limited partnership, an ordinary partnership, or sole trade.
  - Owners of existing QCs and LAQCs have up to six months from the start of their transitional year to tell Inland Revenue that they will restructure their business into a limited partnership, an ordinary partnership, or become a sole trader.
  - The partnership or sole trade must consist of the same person(s) who owned the QC or LAQC.
  - The transition into the new business form must be completed by the end of the transitional year.