

McINTYRE DICK & PARTNERS



CHARTERED ACCOUNTANTS & BUSINESS ADVISORS

# QC & LAQC REGIME CHANGES

# LOOK THROUGH COMPANIES

Brad Phillips

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# Introduction

- Company 101
  - Imputation
  - 30% tax rate – timing advantage only
- QC & LAQC regime changes
  - Repeal of LAQCs
  - Options available for QCs
  - Issues & opportunities
- New Look Through Company (LTC) vehicle
  - Rules
  - Issues & opportunities

# Company 101 - Imputation

- Paper record of “income tax” paid by a company
- Known as imputation credits
- Attach to dividends paid
- Introduced to avoid issue of double taxation

# Company 101 - Imputation

## Without imputation

### Company

|                        |       |
|------------------------|-------|
| Profit                 | \$100 |
| Tax @ 30%              | \$30  |
| NPAT/Retained earnings | \$70  |

### Shareholder

|                    |      |
|--------------------|------|
| Dividend           | \$70 |
| Tax @ 33%          | \$23 |
| NPAT               | \$47 |
| Effective tax rate | 53%  |

## With imputation

### Company

|                        |       |
|------------------------|-------|
| Profit                 | \$100 |
| Tax @ 30%              | \$30  |
| NPAT/Retained earnings | \$70  |

### Shareholder

|                        |        |
|------------------------|--------|
| Dividend               | \$70   |
| Imputation credit      | \$30   |
| Total dividend         | \$100  |
| Tax @ 33%              | \$33   |
| Less imputation credit | (\$30) |
| Tax payable            | \$3    |
| NPAT                   | \$67   |
| Effective tax rate     | 33%    |

# Company 101 - Imputation

- Fully imputed retained earnings = income tax has been paid on all amounts in retained earnings
- Fully imputed if ICA / Retained earnings  $\geq$  42.86%
- Unimputed retained earnings = income tax has not been paid on all amounts in retained earnings

# Company 101 - Imputation

## With imputation

### Company

|                        |       |
|------------------------|-------|
| Profit                 | \$100 |
| Tax @ 30%              | \$30  |
| NPAT/Retained earnings | \$70  |

Retained earnings = \$70

ICA = \$30

### Shareholder

|                        |        |
|------------------------|--------|
| Dividend               | \$70   |
| Imputation credit      | \$30   |
| Total dividend         | \$100  |
| Tax @ 33%              | \$33   |
| Less imputation credit | (\$30) |
| Tax payable            | \$3    |
| NPAT                   | \$67   |

$30 / 70 = 42.86\%$

Fully imputed retained earnings

Effective tax rate 33%

# Company 101 – 30% tax rate

- Generally, company tax rate is not a final tax
- Company profits are taxed in company's name then taxed again in shareholder's name as dividends
- Tax rate of shareholder determines final tax rate company profits are taxed at
- Can delay paying tax at higher tax rates if company profits are not required to be paid out immediately

# Company 101 – 30% tax rate

## Company

|                        |       |
|------------------------|-------|
| Profit                 | \$100 |
| Tax @ 30%              | \$30  |
| NPAT/Retained earnings | \$70  |

## Shareholder

|                        |        |
|------------------------|--------|
| Dividend               | \$70   |
| Imputation credit      | \$30   |
| Total div              | \$100  |
| Tax @ 33%              | \$33   |
| Less imputation credit | (\$30) |
| Tax payable            | \$3    |
| NPAT                   | \$67   |

Effective tax rate 33% = individual's tax rate not the company tax rate

# QC & LAQC regime changes

- Cannot elect to enter QC regime from
  - 2012 year onwards – March to Sept balance dates
  - 2013 year onwards – Oct to Feb balance dates
- Can still elect to be a QC if first tax year of filing tax return is
  - 2011 – March to Sept balance dates
  - 2012 – Oct to Feb balance dates
- LAQC rules repealed from
  - 2012 – March to Sept balance dates
  - 2013 – Oct to Feb balance dates
  - No losses can be attributed going forward
- Can still remain a QC but future uncertain

# Options available

- Remain a QC
- Become a normal company
- Become a LTC
- Transition business to a partnership
- Transition business to a sole trader
- Transition business to a trust

# Remain a QC

- Company pays tax on profits and retains losses
- Capital gains distributed tax-free without winding up company
- Could be a tax cost transferring to another entity later on due to uncertainty of QC regime
- Limited liability
- No time or cost involved

# Remain a QC

- 30% tax rate advantage – timing issue only
- Unimputed retained earnings can be distributed tax-free

# Become a normal company

- Revoke QC elections from start of
  - 2012 year onwards – March to Sept balance dates
  - 2013 year onwards – Oct to Feb balance dates
- Profits taxed in company, losses retained in company
- Capital gains not tax free if distributed other than on liquidation
- Possibility imputation credits lost when QC elections revoked resulting in a tax cost

# Become a normal company

- 30% tax rate advantage – timing issue only
- Future changes in shareholdings may result in imputation credits/tax losses being forfeited
- Unimputed retained earnings cannot be distributed tax-free
- May require interest to be charged or Fringe Benefit Tax (FBT) paid on overdrawn current accounts/inter-entity loans

# Become a normal company

- Automatic deduction for interest
- Limited liability
- Minimal costs and time involved to do this option

# Transition to a Sole Trader

- QC sells business to a sole trader
- Tax concessions apply if transition takes place during transitional year:
  - 2012 or 2013 tax years – March to Sept balance dates
  - 2013 or 2014 tax years – Oct to Feb balance dates
- Treated as a sole trader for whole of tax year in the year in which the transition takes place

# Transition to a Sole Trader

- Tax concession:
  - Sole trader takes over tax position of QC
  - No tax payable by QC on disposal to sole trader
  - QC ignored for tax purposes
  - Sole trader essentially treated as always being in existence
- Written notice to IRD within six months of the start of the transitional year
- Sole trader must be constituted on or before end of transitional year

# Transition to a Sole Trader

- QCs must have one natural person shareholder when process is complete
- Opportunity to restructure shareholding before transitional tax year to ensure requirements met
- Income and losses taxed in individual's name
- Possibly high costs and lots of time involved

# Transition to a Sole Trader

- No limited liability
- Losses to carry forward from QC allocated to sole trader to utilise
  - no limitation on claiming carry forward losses c.f. p'ship
- No access to 30% tax rate

# Transition to a Partnership

- Includes general and limited partnerships
- QC sells business to a partnership
- Tax concessions apply if transition takes place during transitional year:
  - 2012 or 2013 tax years – March to Sept balance dates
  - 2013 or 2014 tax years – Oct to Feb balance dates
- Treated as a partnership for whole of tax year in the year in which the transition takes place

# Transition to a Partnership

- Tax concession:
  - Partnership takes over tax position of QC
  - No tax payable by QC on disposal to partnership
  - QC ignored for tax purposes
  - Partnership essentially treated as always being in existence
- QC status must be revoked within six months of the start of the transitional year
- Written notice to IRD within six months of the start of the transitional year

# Transition to a Partnership

- Partnership must be constituted on or before end of transitional year
- Partnership must have same partners as the people who were shareholders of the QC
- Limited partnerships can introduce a company as a general partner
- Partners must have same rights to assets and liabilities of partnership as they would on wind up of the QC

# Transition to a Partnership

- Not all assets and liabilities of QC need to be transferred to partnership
  - If inappropriate for partnership no need to transfer
- Opportunity to restructure shareholding before transitional tax year to get partners' shares correct
- Watch shares being transferred during transitional year before partnership is constituted –treated as a disposal of each partner's share of assets and liabilities, not treated as a share transfer

# Transition to a Partnership

- Possibly high costs and lots of time involved
- No limited liability for general partnerships or general partners
- Partners taxed in their own name on share of partnership income or losses
- No access to 30% tax rate

# Transition to a Partnership

- Losses to carry forward from QC allocated to partners of the partnership
  - Can claim loss only to extent of partnership income returned
  - Unused losses carried forward to future income years
- Rules apply for determining “partners basis” for loss limitation rules (limited partnerships only)
  - Limited partners’ losses limited to their “partner’s basis”
  - Unused loss can be carried forward to future income years

# Become a LTC

- QC remains a company but taxed as a LTC
- Tax concessions apply if transition takes place during transitional year:
  - 2012 or 2013 tax years – March to Sept balance dates
  - 2013 or 2014 tax years – Oct to Feb balance dates
- Tax concession:
  - LTC takes over tax position of QC
  - No tax payable by QC on transition to LTC
  - LTC essentially treated as always being in existence

# Become a LTC

- Elections to become a LTC must be received within six months of the start of the transitional year
- Opportunity to restructure shareholding before transitional tax year to get owners' shares correct
- Watch if shares transferred during transitional year as treated as a disposal of an owner's share of assets and liabilities, not treated as a share transfer
- Minimal costs and time involved to become a LTC

# Become a LTC

- Limited liability
- Company not taxed, shareholders taxed on their share of income/losses
- No access to 30% tax rate
- Losses to carry forward of QC allocated to the shareholders of the LTC
  - Can claim losses only to extent of LTC income returned
  - Unused losses carried forward to future income years

# Transition to a Trust

- No tax concessions
  - Normal tax rules apply to disposal
  - Depreciation recoveries, disposal of trading stock/livestock
- Option has not been allowed for in legislation
- No ability to claim losses forfeited by QC
- Possibly high costs and lots of time involved
- Unlikely to be an option

# Issues of transition to a Sole Trader, Partnership or Trust

- Property to be valued at market value for transfer
  - valuation fees
  - Companies Act requirement to act in good faith and in best interests of the company
- Property needs to be transferred
  - Lawyer's fees
  - Change of vehicle registrations
  - Update Personal Property Securities Register
  - Insurance policies

# Issues of transition to a Sole Trader, Partnership or Trust

- If goodwill not valued is there a gift?
  - Sliding value clauses
  - Removal of gift duty
- New employment agreements required
  - Lawyer's fees
  - Opportunity to update and review
- Mortgage discharge fees and break fees

# Issues of transition to a Sole Trader, Partnership or Trust

- Costs of setting up new structure
  - Partnership agreements / Trust deed
- Require IRD approval to pay wages to spouse, civil union partner or de facto partner
- Shareholder previously receiving a PAYE salary from company
  - If transfer to a sole trader will become subject to provisional tax and possibly IRD use of money interest (UOMI)

# Issues of transition to a Sole Trader, Partnership or Trust

- Shareholder previously received a shareholder salary without PAYE deducted
  - No ability to do this for partnerships or trusts
  - Partners can only claim a deduction for payments to working partners if made under a contract of service
    - Needs to be in writing
    - PAYE required to be deducted
- Costs of winding up company
- No automatic deduction for interest

# Issues of transition to a Sole Trader, Partnership or Trust

- 100% deductions and paying FBT vs Claiming business portion and no FBT
- Apply for non-standard balance dates
- Leases
- Update Supplier/Client contracts
- Update personal guarantees
- How important is limited liability?
  - Prospect of failure?
  - Insurance

# Issues of changing to a Sole Trader, Partnership or Trust

- How important is asset protection/asset planning?
- Is a relationship property agreement required?
- How important is the 30% tax rate?
- Wills need reviewed and updated
- Customers/suppliers need advised of change of structure
- Stationery, signage and marketing material may need changed
- Bank accounts will need closed and new ones opened

# Issues of changing to a Sole Trader, Partnership or Trust

- GST
  - New entity needs to be registered at time of transfer
  - Watch associated persons time of supply rules
  - Need deeds of acknowledgment of debt to constitute payment for GST purposes
  - Does new entity need to apply for buyer created tax invoice status?
  - If vendor GST registered but purchaser not, transaction will be at market value – vendor pays GST but no claim for purchaser
  - Land zero-rated from 1 April 2011 in some situations

# Opportunities of changing to a Sole Trader, Partnership or Trust

- An excellent time to get some structures tidied up without a tax cost
- Foreign Investment Funds (FIFs)
  - Comparative Value (CV) method only available to individuals and trusts
  - \$50k De-minimus rule applies to natural persons only
- UOMI
  - individuals not subject to UOMI if RIT < \$50k and do not estimate

# Opportunities of changing to a Sole Trader, Partnership or Trust

- Exiting company tax rules may get around issue of having to charge interest on overdrawn current accounts
- Foresters cannot use income equalisation scheme if a company so use LTC
- No requirement to prepare an imputation credit account
- Going to a sole trader or partnership may entitle individual to the early tax repayment discount
- Portfolio Investments Entities (PIE's)
  - Opportunity to elect a lower Prescribed Investor Rate (PIR)

# Opportunities of changing to a Sole Trader, Partnership or Trust

- Kiwisaver – automatic enrolment rules do not apply when business transferred to a new entity
- No Companies Act requirements to be met
- No further tax payable on retained earnings that are distributed
  - Advantage if on higher tax rate than company tax rate
- If shareholders on lower tax rate than company tax rate pay a dividend out in year before transitional year to get tax benefit of surplus imputation credits

# Look Through Company (LTC)

- It is still a company
  - subject to Companies Act requirements
- Not treated as a company for income tax purposes
- Has its own set of tax rules
  - Similar to partnership tax rules
- Aimed at family owned businesses
  - Avoid using for unrelated parties in business
  - If have trusts as shareholders tread with care

# Look Through Company (LTC)

- Requirements
  - Meets the definition of a “look through company” at all times during the year; and
  - Valid elections have been received by IRD for the income year; and
  - Valid elections have not been revoked

# LTC – Definition

- Has to be a company; and
- Tax resident in NZ (domestic law or Double Tax Agreement); and
- Not treated as non-resident under a DTA; and
- 5 or fewer “look-through counted owners”; and
- Is not a flat-owning company; and
- Has only shares that are “look-through interests”; and
- A valid election has been received

# LTC – Valid Elections

- Requirements:
  - IRD provided with written notice, signed and dated by a director specifying the first income year for which it is valid; and
  - Attached written notices signed and dated by all shareholders ; and
  - Unanimous agreement by all shareholders to be a LTC
- Under 18 or legally incapacitated
  - required to be signed and dated by guardian, PoA, legal rep

# LTC – Valid Elections

- Receipt of elections:
  - Before start of income year specified in election; or
  - Before last day of filing tax return if company has not previously filed a tax return; or
  - Within six months of the start of the transitional year
- Election treated as received for the year for which the election was made and every subsequent year unless:
  - Election revoked; or
  - Company does not meet definition of LTC; or
  - Income year is one of the two income years straight after the income year the company ceases to be a LTC or an election has been revoked

# LTC – Valid Elections

- Late election or unsigned treated as valid if all relevant people subsequently sign and date during the income year and IRD decides exceptional circumstances are the sole cause of the mistake
- Revocation of elections
  - Takes effect from start of income year following the year the notice was received
  - Only takes one shareholder to revoke LTC election!!
  - Revocation received after start of income year is treated as received for the year if IRD decides exceptional circumstances are sole cause of the late revocation
  - Revocation by an owner ignored if ALL of that shareholder's shares are sold and new shareholder sends written notice to IRD reversing revocation, before start of income year

# LTC – Look-through counted owners

- Means:
  - a natural person shareholder
  - a natural person beneficiary who has received income from a LTC for the current income year or one of the last 3 income years
  - is a trustee of a trust who has not distributed all income from a LTC for the current income year and all of the last 3 income years
  - Is a natural person that has a voting interest in a company that has received, as beneficiary income, income from a LTC for the current income year or one of the last 3 income years

# LTC – Look-through counted owners

- A company (tax meaning) cannot be a shareholder in a LTC
- Co-trustees treated as one person
- Relatives are treated as one person
- A LTC can be a shareholder in a LTC

# LTC – Look-through interest

- Means a person's shares in a company if
  - have the same proportional rights to vote or participate in any decision-making concerning:
    - Distributions; and
    - Constitution; and
    - Varying capital; and
    - Appointing or electing directors; and
  - have same rights proportionally, whether on liquidation or not, when company:
    - Distributes profits or assets; and
    - Acquires, redeems or cancels its shares; and
    - Reduces or returns share capital; and
  - Only shareholders are natural persons, corporate trustees or LTC's
- Need to check company constitutions and shareholder agreements to ensure above requirements are met

# LTC – Tax treatment

- LTC not taxed on profits
- Shareholders of LTC are taxed on their share of profit or loss
- Shareholders are allowed a deduction for payments to “working owners” only if payment under a written contract of employment
  - Cannot pay a shareholder’s salary
  - Need to personally and actively perform duties
  - Need to deduct PAYE

# LTC – Tax treatment

- Any tax losses arising before electing to be a LTC are extinguished
  - normal companies becoming a LTC or QCs becoming LTCs outside transitional years
  - utilise losses before entering regime
- If company ceases to exist deemed disposal of shareholder's interest to a single third party for market value
  - Tax issues for shareholders
  - Disposal of shareholder's share of assets & liabilities at market value

# LTC – Tax treatment

- If shareholder's share capital is reduced by cancellation or buy-back, other than on a pro-rata basis, deemed disposal of shareholder's interest to a single third party for market value
- If company ceases to meet LTC requirements shareholders' deemed to dispose of their interest and reacquire their interest to/from single third party at market value
  - Tax issues for shareholders
  - Disposal of shareholder's share of assets & liabilities at market value
  - Reverts to a normal company

# LTC – Tax treatment

- If change in composition of shareholders need to consider entry/exit tax rules
- If consideration received by exiting shareholder does not exceed their proportion of tax value of assets less liabilities by \$50k no tax consequences for exiting or entering owner
- Entering owner treated as originally acquiring and holding interest
- If exceeds by \$50k then tax consequences for exiting owner => sale of shareholder's share of assets and liabilities

# LTC – Tax treatment

- BUT some concessions apply to tax consequences:
  - Depreciable property
  - Financial arrangements
  - Livestock
  - Trading stock
- Loss limitation rule
  - Shareholder denied an income tax deduction for their share of LTC loss when it is greater than their “owner’s basis”
- Losses limited to balance of shareholders’ capital and current accounts, income/losses allocated and personal guarantees

# LTC – Tax treatment

- Un-utilised losses can be carried forward to future income years to be claimed
- Cannot claim a deduction for losses carried forward if company ceases to be a LTC or shareholder ceases to have an interest in the LTC
- Dividends paid by a LTC are tax-free in the hands of the shareholders

# LTC – non-QCs entering LTC regime

- Following rules also apply to QCs that transition to a LTC outside the following timeframes:
  - 2012 or 2013 tax years – March to Sept balance dates
  - 2013 or 2014 tax years – Oct to Feb balance dates
- Shareholder has income, in the year of the company becoming a LTC, equal to their share of the untaxed retained earnings of the company

# LTC – non-QCs entering LTC regime

- An issue for companies if they have tainted capital gains or unimputed retained earnings
- If retained earnings fully imputed a tax advantage for shareholders on highest tax rate
  - no income to shareholder
  - final tax at company tax rate
  - no further tax payable on dividends received from LTC

# LTC – ceasing to be a LTC

- Retained earnings and capital profits of LTC up until time of ceasing to be a LTC can still be distributed to shareholders tax-free
- Dividends are first paid from LTC retained earnings and reserves
- Taxed as an ordinary company
- Tax issues for shareholders on cessation
  - Disposal of shareholders' share of assets & liabilities at market value

# LTC – Issues

- Only takes one shareholder to revoke election
- If cease to be LTC then deemed disposal of interest at market value for shareholders
- If dispose of shares in LTC then deemed disposal of interest at market value for shareholder
- Owner count test includes beneficiaries who have received LTC income in prior years from trust shareholder
- A company cannot be a shareholder
- Loss limitation rule

# Look Through Company – Opportunities

- No restriction on foreign-sourced income
- No requirement for trusts to pass dividends onto beneficiaries
- No director elections required
- No election for shareholders to take personal liability for LTC's income tax
- No revocations by event
- No interest on overdrawn shareholder current accounts

# Where to from here?

- Will contact clients and discuss options with them
- Will review all issues identified in presentation
- Make a recommendation to clients
- Put an action plan in place
- Questions