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A special report from the
Policy Advice Division of Inland Revenue

Changes to qualifying company rules

This special report provides early information on changes to the rules for qualifying companies, which were part of recently enacted legislation in the Taxation (GST and Remedial Matters) Act 2010.

This special report precedes coverage of the new legislation that will appear in a *Tax Information Bulletin* to be published early next year.

The relevant changes introduced in the Act:

- provide transparent income tax treatment for electing closely held companies, which will be known as look-through companies (LTCs);

- allow existing qualifying companies (QCs) and loss-attributing qualifying companies (LAQCs) to continue to use the current QC rules without the ability to attribute losses, pending a review of the dividend rules for closely held companies; and

- allow existing QCs and LAQCs to transition into the new LTC rules or change to another business vehicle such as a partnership, without a tax cost during the period 1 April 2011 to 31 March 2013.

This report is intended to provide timely assistance to those with existing QCs and LAQCs to help them understand the changes to the tax rules. Any decision on future business structures will need to take into account a wide variety of factors, both tax and non-tax related – for example, the protection of limited liability. Existing QC and LAQC owners will need to consider their own circumstances when making their decisions, and may want to seek assistance from their professional advisor if necessary.

A separate special report contains guidance on the new LTC rules.

Further guidance on the changes to the qualifying company rules will be available over the coming months on Inland Revenue's website and in a *Tax Information Bulletin*.

Background

As part of Budget 2010 the Government announced reforms to the tax rules for qualifying companies. Feedback on the proposals was sought in the officials' issues paper, *Qualifying companies: implementation of flow-through tax treatment* published the day after the Budget announcement.

Based on this feedback, it was decided to introduce new rules from 1 April 2011, providing an elective look-through income tax treatment for closely held companies. These are covered in a separate special report.

In addition, in response to feedback from small businesses, the Government decided to allow existing QCs and LAQCs to continue to use the current qualifying company rules, but without the ability to attribute losses, while a review of the tax rules for dividends from closely held companies is carried out.

Because of the changes to the qualifying company rules, a special set of transitional rules were developed, to allow existing QCs and LAQCs to transition into the new LTC rules or change to another business vehicle such as a partnership or sole trader, without a tax cost.

An early draft of this legislation was made available for public comment on 15 October 2010, accompanied by an explanatory note. The final legislation, which was enacted on 20 December 2010, is different from the earlier draft, reflecting feedback received during consultation. Some of these changes are fairly substantial while others are more technical in nature. The earlier draft of the legislation and the explanatory note have therefore been superseded by the enacted rules and should not be relied upon.

Key features

Qualifying company rules

The changes effectively "grandparent" the QC rules for existing QCs and LAQCs only. The revised QC rules will continue to apply to existing QCs and LAQCs unless they choose to revoke their QC election, and/or use one of the transition options (see below).

The main effect of the changes is to:

- remove the ability of an LAQC to attribute losses. This means that existing LAQCs will effectively be taxed in the same way as ordinary QCs; and

- prevent companies that are not already QCs from entering the QC rules for income years starting on or after 1 April 2011.

The changes apply to QCs and LAQCs for income years starting on or after 1 April 2011.

Transitional rules for existing QCs and LAQCs

Special transitional rules allow existing QCs and LAQCs to transition into the new LTC rules or change to another business vehicle, without a tax cost.

If an existing QC or LAQC chooses not to transition they will remain in the QC rules, but cannot attribute losses to shareholders.

The transitional rules provide that:

- Transition can take place in either one of the first two income years starting on or after 1 April 2011; the year chosen for transition is called the "transitional year".

- QCs and LAQCs have six months from the start of their transitional year to advise Inland Revenue of their transition.

- If transitioning to a new business structure, the partnership or sole tradership 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.

- The appropriate tax treatment (LTC, partnership or sole trader) will apply from the start of the transitional year.

- All of the QCs assets, liabilities, tax balances and other obligations will automatically transfer to the new LTC, partnership or sole trader with no tax cost.

- Any carried forward loss balances of a QC or an LAQC can be used in future but are effectively ring-fenced for owners of the LTC, or partners in the partnership, to use against future income from that LTC or that partnership.

Application dates

The application date for the qualifying company reforms is the income year starting on or after 1 April 2011.

For companies with an early balance date – for example, an LAQC with a balance date of 31 January, they will have loss attribution for their income year ended 31 January 2012 but will no longer be able to attribute losses for their income year starting on 1 February 2012.

To use the grandparented QC regime, QCs and LAQCs must have used the QC regime for their income year immediately before the income year starting on or after 1 April 2011.

If transitioning in the second of the possible transitional years, they must also have met the QC criteria for the whole of the first possible transitional year.

Detailed analysis

Grandparented qualifying company rules
Sections HA 1, HA 3, HA 5, HA 7B, HA 10, HA 11(4), HA 20, HA 24 to HA 27, HA 30(3), HA 38 to HA 39 and YA 1

Existing QCs and LAQCs may continue to use the qualifying company rules in subpart HA, without the ability to attribute losses. This will be the default option for all existing QCs and LAQCs for income years starting on or after 1 April 2011.

The definition of an LAQC and the various provisions in subpart HA which provided for an LAQC to attribute losses to its shareholders have been repealed.

The grandparenting rules apply only to companies that are QCs or LAQCs in the income year immediately before the income year starting on or after 1 April 2011; this is called the "grandparenting income year".

Existing QCs and LAQCs include companies already registered with Inland Revenue as QCs or LAQCs, and companies such as newly incorporated companies, for whom the grandparenting income year is the first year for which they are required to submit a return of income, and who send their valid election to Inland Revenue within the timeframe allowed in section HA 30(3).

Transitional rules for existing QCs and LAQCs
Sections CB 32C, DV 21, DV 23, DV 24, HA 33B, HZ 4B to HZ 4D and YA

The transitional rules apply only to companies that are QCs or LAQCs in the income year immediately before the income year starting on or after 1 April 2011. If they are transitioning in the second of the possible "transitional" years they must also have met the QC criteria for the whole of the first possible transitional year.

Transition can take place in either one of the first two income years starting on or after 1 April 2011. The year chosen for transition is called the "transitional year".

The transitional rules are designed to provide a smooth transition for existing QCs and LAQCs to leave the QC rules and start using the LTC rules if they wish to do so.

They also provide an option for existing QCs and LAQCs to transition their business structure into a partnership, limited partnership or sole trader, with no tax cost. This transition will require the setting up of the alternative business structure, and the transfer of assets, liabilities, legal titles and so forth from the QC to the chosen structure. These changes will be completed under the relevant general tax rules; they are not dealt with in the transitional rules, which are concerned solely with tax matters arising from, during or after the transfer.

The transitional rules are deliberately outcome focused. The exact process each QC will need to complete in order to transition will vary according to its existing structures and governance. Any interim measures necessary to transition will generally be ignored, as long as the new business structure is in place by the end of the chosen transitional year.

All of the necessary transfers of assets and liabilities, plus all other legal documentation necessary in the new business structure must be completed by that date. However the tax treatment of the new business structure (that is a partnership or sole tradership) will be applied from the start of the transitional year. This effectively provides a QC or LAQC with up to 12 months to reconstitute its business structure.

Transitioning to the LTC rules

All the shareholders of the existing QC or LAQC must complete the LTC election within six months of the start of the transitional income year. Making the LTC election revokes the previous QC and LAQC elections with effect for, and from the beginning of that transitional income year.

When an existing company becomes an LTC its owners are usually treated as having an amount of taxable income equal to their proportion of the amount of the company's reserves that would be taxable if the company were to be liquidated and its assets distributed. However, under the transitional provision no income amount will arise, and so no tax will be paid by owners when an existing QC or LAQC transitions to become an LTC.

The carried forward loss balance of a QC, and any controlled foreign company (CFC) or foreign investment fund (FIF) losses carried forward by an LAQC, may be used by the owners of the LTC in future years against their share of net income from that LTC. For CFC or FIF losses carried forward, the normal country ring-fencing rules in subpart IQ will apply too.

The LTC loss limitation rules do not affect an owner's claim to these brought-forward losses.

For the purposes of the LTC loss limitation rules, there are two options for determining an owner's basis:

- the market value or the accounting book value of the amounts used to determine a owner's basis for the loss limitation rules. These values should be taken at the last day of the transitional year; and

- the historic basis, as if the LTC rules had always applied and the LTC had always existed.

If the application of the loss limitation rules calculates an owner's basis at less than zero, the owner's basis is treated as zero.

Transition to a partnership or limited partnership

Existing QCs and LAQCs may transition to become a partnership or a limited partnership during their transitional year under the "QCP transitional process".

This means that during the transitional year, the QC or LAQC must notify Inland Revenue that it intends to become a partnership or limited partnership under the QCP transitional process. Notification should be made within six months of the start of the transitional year. This notification will revoke its QC status from the start of that transitional year.

The partners of the partnership that emerges following the transition should be the same as the shareholders of the QC. One exception to this is a limited partnership, when a company may be used as the general partner with the shareholders of the QC being the limited partners.

Each partner should have the same relative interests in the partnership as in the QC. If several QCs transition into one partnership it is the net position of the partners following transition that should be compared.

Example 1: Transition into partnership

Mr A and Mr B each own 50% of AB Ltd, an LAQC with net assets of $3,000.

Mr X and Mr Y each own 50% of XY Ltd, a QC with net assets of $12,000.

They form a new limited partnership which has partnership net assets of $15,000. Each individual is a limited partner and Alphabet Ltd is incorporated to become the general partner.

Mr A and Mr B will each hold a 10% partnership share ($1,500 of the partnership's assets).

Mr X and Mr Y will each hold a 40% partnership share ($6,000 of the partnership's assets).

Alphabet Ltd is the general partner, but holds no partnership share.

The carried forward loss balance of a QC, and any CFC or FIF losses carried forward by a LAQC, may be used by the partners of the partnership in future years, against their share of net income from that partnership. In the case of CFC or FIF losses carried forward, the normal country ring-fencing rules in subpart IQ will also apply.

The limited partnership loss limitation rules do not affect a limited partner's claim to these brought-forward losses.

For the purposes of the limited partnership loss limitation rules, there are two options for determining the partners' basis of a limited partnership:

- the market value or the accounting book value of the amounts used to determine a member's basis for the loss limitation rules. The values are taken at the last day of the transitional year; and

- the historic basis, as if the limited partnership rules had always applied and the limited partnership had always existed.

If the application of the loss limitation rules calculates a partner's basis as less than zero, the partner's basis is treated as zero.

Transition to sole trader

Existing QCs and LAQCs with only one natural person shareholder may transition to become a sole tradership during their transitional year under the "QCST transitional process".

This means that during the transitional year, the owner of the QC or LAQC must notify the Commissioner that he or she intends to operate as a sole trader, and transition the business under the QCST transitional process. Notification should be made within six months of the start of the transitional year. This notification will also revoke the company's QC status from the start of that transitional year.

The carried forward loss balance of a QC, and any CFC or FIF losses carried forward by an LAQC, may be used by the sole trader in future years. In the case of CFC or FIF losses carried forward, the normal country ring-fencing rules in subpart IQ will apply.

Tax outcomes of completing the QCP or QCST transitional process

As long as the QCP or QCST transitional process is completed by the end of the chosen transitional year any income and expenses during the transitional year will be treated as arising to the partnership or the sole trader from the start of the transitional year, even if, as a matter of fact, they actually arose during a part of the transitional year when the business was still in a corporate form.

If the QCP or QCST transitional process is not completed by the end of the transitional year the company will be taxed as an ordinary company for that year, as its QC status has been revoked. There may also be tax consequences from the parts of the incomplete transition that have already been carried out.

Under the QCP and QCST transitional process there is no tax cost arising from the transfer of assets, liabilities and any relevant rights and obligations from the QC to the partnership or sole trader. The historical tax position of the QC instead transfers to the partnership or sole trader; this means any future adjustments to income or deductions relating to the QC period will be dealt with through the partnership or the sole trader.

The memorandum account balances and other related tax accounts (such as ASC) for a company that was a QC or LAQC before the transition are extinguished. The company effectively becomes a "shell" company, and may be liquidated or written off the Company Register.