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CHARTERED ACCOUNTANTS

YOU & YOUR QUALIFYING COMPANY

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The information presented in this brochure is necessarily of a general nature and should not be relied upon as a substitute for specific advice. For advice on, or assistance with any of the matters raised, please contact

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A Qualifying Company – What is it?

A company may elect to adopt the tax status of being a Qualifying Company (QC). This is intended to provide a much simpler basis of taxation for small family-type companies where the company is effectively a substitute for a partnership or a sole trader.

The QC regime allows QCs to be treated for tax purposes more like a partnership, while retaining limited liability against creditors, except the IRD in respect of income tax liabilities.

The main difference between partnership taxation and company taxation is the allocation of income. Partners in a partnership account for their share of income in their personal tax return. A QC pays tax on its profit and can then distribute that profit to the shareholders as fully-imputed dividends. Individuals may be faced with extra tax on these dividends, if their tax rate is higher than that of the company.

Capital profits of QC's are able to be distributed to shareholders tax-free without the company being wound up and, where certain criteria are met, net losses will be able to flow through to be offset against the shareholder's personal income.

Generally, most companies should be QCs, but an assessment is necessary for each company.

A Qualifying Company – What's Involved?

Criteria to be a QC

A company must apply to become a QC and needs to satisfy the following criteria at all times:

- There can only be five or fewer shareholders (persons related to within the first degree are counted as one shareholder).
- Each shareholder must be an individual, another QC, or a family trust.
- All shareholders aged over 20, and all directors, must agree in writing that the company becomes a QC.

- All shareholders aged 20 or over must agree to become liable for a share of any income tax not paid by the company.
- The company must not be classed as a non-resident for tax purposes.
- The company must not receive more than NZ\$10,000 of foreign income (other than dividends).

Five or Fewer Shareholders

There are special rules used in determining the number of shareholders.

- Husbands, wives, parents and children in one family are counted as one shareholder.
- Where a trust is a shareholder, the count is based on the greater of:
 - the number of beneficiaries who have received dividends from the QC via the trust, or
 - the number of beneficiaries who agreed in writing that the company becomes a QC.
- Where one company holds shares in another company the count is applied to the number of shareholders in the controlling company.

Family Trust Shareholders

The two rules that must be met are:

- The trust must distribute all dividends received from a QC to beneficiaries as beneficiaries income.
- The beneficiaries who receive this income must be either an individual or another QC.

Advantages of being a QC

- Some dividends can be paid tax-free.
- Capital gains (both realised and unrealised) can be distributed to shareholders tax-free without the need to wind up the company.

Disadvantages of being a QC

- There may be tax costs involved on entry (tax on retained earnings and some capital profits).
- Shareholders become personally liable for a share of any income tax unpaid by the company.
- Tax losses brought forward from previous years are forfeited on becoming a QC.
- Continuing compliance costs to ensure QC status is retained.
- QC losses can be offset against any group company profits but a non-QC loss cannot be offset against a QC profit.

A Loss Attributing Qualifying Company (LAQC) – What's Involved?

A QC may, as a second step, elect to become a LAQC with the result that losses incurred are offset against shareholders' other personal income

Criteria to be an LAQC

- The company must be a QC.
- All shareholders aged over 20 and all directors must agree in writing that the company becomes an, LAQC.
- All shares must be of one class with the same rights.

Advantages of being an LAQC

In addition to the advantages of being a QC, shareholders of an LAQC must offset tax losses incurred by the company against their own personal assessable income. This avoids the losses being locked up within the company structure where they would otherwise only be available to offset against future years' profits.

Disadvantages of being an LAQC

When the company allocates losses to shareholders, it may appear to be insolvent as the Statement of Financial Position may show negative shareholders' funds. To eliminate that position, the company could either issue further share capital (ie the shareholders contribute new funds) or retain profits after paying company tax.

LAQC Tax Losses

Tax losses incurred by an LAQC must be allocated to the shareholders with the amount allocated to each shareholder being based on the number of shares each shareholder holds.

For example, if a shareholder has 40% of the shares in an LAQC then that shareholder will be allocated 40% of any tax losses incurred by the LAQC.

Application to Become a QC/LAQC

Company Applications

QC/LAQC application forms must be completed and signed by the following:

- All directors on behalf of the company.
- All shareholders who are individuals aged 20 or over.
- All trustees, and at least one beneficiary who is aged 20 or over, on behalf of trust shareholders.
- The directors of any shareholder company which holds shares in the QC.

Where a shareholder is a trust and the trust's beneficiaries are all natural people under the age of 20, then an individual aged 20 or over must sign the forms and assume responsibility for the trust's portion of the company's income tax payable.

A majority shareholder (a shareholder or group of shareholders who own 50% or more of the shares) can sign the application forms on behalf of a minority shareholder. This may arise where a minority shareholder declines to accept the liability for company tax payable by the QC. The majority shareholder then assumes the liability on behalf of the minority shareholder.

Effective Date of QC/LAQC Elections

- **For a company which has previously filed income tax returns**

The signed application forms are filed with the Inland Revenue Department and the QC status is effective at the beginning of the income year following the year in which the IRD receives the forms (eg forms are received by IRD on 30 June 2008, QC/LAQC status applies from 1 April 2009).

- **For a new company that has not yet filed its first income tax return**

The QC status is effective at the beginning of its first income year.

Cost of Becoming a QC/LAQC

On application, Qualifying Company Election Tax (QCET) may be payable. QCET is a one-off tax on the retained earnings and some capital profits of the company that can be distributed to shareholders as dividends.

In addition, any accumulated tax losses are forfeited. If profits were expected to be generated in the immediate future, entry to the regime should be deferred until all the losses have been utilised.

A QC pays only two types of dividends:

- (a) taxable dividends with tax credits attached
- (b) tax-free dividends

Dividends from a QC/LAQC

A company pays taxable dividends to the extent of the amount of imputation credits it has available. After that the dividends the company pays are tax-free.

Taxable and tax-free dividends received by a shareholder are calculated as:

Net Dividend	\$25,000
Imputation Credits attached	\$6,000
Gross Dividend	\$31,000

The apportionment becomes –	
Imputation Credits	\$6,000
Divided by Company tax rate eg	0.30
Taxable Dividend	\$20,000

Gross Dividend	31,000
Less Taxable Dividend	20,000
	<hr/>
Amount of Tax-Free Dividend	\$11,000
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The shareholders tax position would be –	
Taxable Dividend	20,000
Income Tax (assume 33%)	6,600
Less Imputation Credits	6,000
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Extra Tax Payable	\$600
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Ceasing to be A QC/LAQC

A. *By Shareholders' Actions*

A company ceases to be a QC/LAQC:

1. When a shareholder withdraws their consent by advising the company and the IRD in writing; or
2. On the death of a shareholder; or
3. On the sale of shares, unless the shares are sold to an existing shareholder who was part of the original election; or
4. Where all the beneficiaries of a trust shareholder are under the age of 20 at the time of election to become a QC/LAQC, one of those beneficiaries reaches the age of 20; or
5. Where a majority shareholder becomes a minority shareholder having previously made the application on behalf of a minority shareholder; or
6. Where a minority shareholder becomes a majority shareholder and did not participate in the original application; or

7. Where a joint applicant advises the company and the IRD that they wish to withdraw their consent.

Periods of Grace

Where a shareholder's application to become a QC/LAQC is cancelled by the occurrence of one of the events above, the company has the following time limits in which to restore the status.

- 12 months when a shareholder dies.
- 63 days for the other events.

When replacement application forms are filed with the IRD within these time limits, the company will continue to be a QC/LAQC.

B. By Directors' Actions

The applications made by directors can only be cancelled by a resolution of the Board of Directors.

The Board of Directors must send notice of its cancellation with a copy of the resolution to the IRD. No periods of grace are available once the notice of cancellation has been filed.

The QC/LAQC status of a company is not affected by a change of directors.

When a Company Ceases to be a QC/LAQC

If replacement application forms are not filed within the periods of grace, the company will cease to be a QC/LAQC from the beginning of the income year in which it loses its QC/LAQC status (eg if the QC requirements are breached on 1 August 2008, then the company's QC status is deemed to cease from 1 April 2008).

QCs versus Partnerships

The most obvious difference is that a partnership is not a taxpayer and while a partnership return is filed, it is the partners who pay tax on their share of the income. A QC will pay tax on its income and will then distribute that income to the shareholders by way of dividends and tax credits or tax-free dividends.

Partnership income is automatically allocated to partners. QC income does not have to be distributed to shareholders. The QC may decide to retain some of the income within the company.

QCs can pay tax-deductible salaries to shareholder-employees, unlike the general position in relation to partnerships. The option of extracting profits from a QC as remuneration rather than dividends is retained.

In-kind benefits provided to QC shareholders, who are not also employees, will not be subject to fringe benefit tax (FBT), as they will be classed as dividends to the shareholders. The benefits will be tax-free to the shareholders and the expenses incurred by the company in providing the benefits will be non-deductible.

Shareholders receiving such non-cash dividends will be subject to an interest apportionment if they have borrowed money to acquire shares in the QC. In-kind benefits provided to employees (including shareholder-employees) of a QC will subject the QC to an FBT liability but will remain non-taxable to the employee. Expenses incurred in providing the benefits, including the FBT payments, will be deductible and no interest apportionment is required.

LAQCs and Property Investors

An LAQC is a property ownership structure often favoured by property investors. This provides the opportunity to distribute income at the lowest tax rates and allows rental losses to be offset against other personal income.

As property borrowings reduce and depreciation claims decline, net rents increase and the LAQC will become profitable and be liable to pay company tax. At this point a family trust may acquire LAQC shares. Any further growth in the value of the property would then accrue to the trust and not the individual. Replacement shareholders' applications should be filed by the family trust so that the company retains its QC status. Capital gains could then be distributed to the family trust without winding up the company.

In Conclusion

There is no set formula that can be applied in any particular case, and no factor should be considered in isolation, when determining whether or not your company should become a QC.

Many benefits can be gained from becoming a QC/LAQC, however the costs for an existing company can be quite severe (ie QCET and forfeiture of existing tax losses).

While there is a need to continually monitor the various shareholder applications, such an obligation should not discourage small businesses from becoming a QC.

The principal benefit in the LAQC status is the ability to access losses, which would otherwise be locked up within the company. Accordingly, in most cases, LAQC status should be sought. Under certain circumstances (eg a company wishing to access capital profits tax-free without winding up the company) some may elect only QC status.

The best time to apply for QC/LAQC status is at the commencement of business.

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You and Your Business Plan

You and Your Business Acquisition

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You and Your Qualifying Company

You and Your Review of Performance

You and Your Trust

You are Thinking About Going into Business?

You and Your Wealth Creation

You and GST on Your Real Estate Transactions