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IT'S DECISION TIME!

February 2011

The law outlawing LAQC's was passed on 23 December 2010. The time has come to start considering what advice to give each client.

A last minute change has given a little respite. Instead of the decision having to be made within 6-months of balance date (generally by 30 September 2011) there is now the option of this year or next year.

That is, a QC/LAQC can transition in the 2012 tax year or the 2013 tax year.

We addressed the proposals in *Tax Assessment* June 2010 and December 2010 and so will not cover that detail again.

The choices

QC/LAQC's have six choices. These are:

1. remain as a QC
2. revoke QC status and become an ordinary company
3. transfer assets to a sole trader
4. transfer assets to a partnership
5. transfer assets to a limited partnership
6. elect to become a look-through company ("LTC").

The advantages of **Remaining a QC** include:

1. continuation of limited liability
2. dividends which are not fully imputed are exempt from tax
3. capital gains can be paid out to shareholders tax free without winding up the company whether derived from an associated person or not
4. non-PAYE shareholder - employee salaries can be paid
5. profits taxed at 28%
6. no conveyancing costs or mortgage break fees

The disadvantages of **Remaining a QC** include:

1. losses (if any) accumulate in the company
2. there is to be a review of the dividend rules which may effect the future of QC's so there will be uncertainty in the medium term as to the future of the QC

The advantages of **Revoking QC status and becoming an ordinary company** include:

1. continuation of limited liability
2. non-PAYE shareholder - employee salaries can be paid
3. profits taxed at 28%
4. no conveyancing costs or mortgage break fees

The disadvantages of **Revoking QC status and becoming an ordinary company** include:

1. losses (if any) accumulate in the company
2. non-associated person capital gains can only be accessed tax free on the winding up of the company

The advantages of **Transferring assets to a sole trader or ordinary partnership** include:

1. transition into either of the above structures can occur with no tax cost
2. profits taxed at the personal tax rates
3. no restriction access to losses
4. capital gains accessed tax-free
5. FBT issues for employee owners eliminated
6. lower compliance costs

The disadvantages of **Transferring assets to a sole trader or ordinary partnership** include:

1. loss of limited liability
2. for partnerships, salaries paid to working partners only deductible if there is an employment contract
3. for sole traders, wages paid to a spouse require IRD approval
4. conveyancing costs
5. possible mortgage break fees
6. commercial and employment contracts affected

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7. re-imaging with clients
8. loss of rights to "leaky home" claims.

The advantages of **Transferring assets to a limited partnership** include:

1. continuation of limited liability
2. transition into a limited partnership can occur with no tax cost
3. profits taxed at the personal tax rates
4. capital gains accessed tax-free
5. FBT issues for working partners eliminated

The disadvantages of **Transferring assets to a limited partnership** include:

1. use of losses may be restricted
2. higher compliance costs
3. salaries paid to working partners only deductible if there is a contract
4. limited partners need to be careful with their involvement so as to preserve limited liability
5. cost of establishment
6. conveyancing costs
7. possible mortgage break fees
8. commercial and employment contract affected
9. re-imaging with clients
10. loss of rights to "leaky home" claims.

And then there is the "look through company" ("LTC")

To recap, an LTC is a company where the shareholders elect that, for income tax purposes only, it is treated differently. To be an LTC:

1. the company must be New Zealand tax resident
2. the shareholders must be either individuals, trusts or another LTC
3. an LTC must have five or fewer "shareholders" which is determined in a similar way to QC's except that trustees of a trust are regarded as one subject to certain limitations
4. an LTC must have only one class of shares
5. all income, expenses, tax credits and rebates are passed on to the shareholders in accordance with their effective interest in the LTC
6. losses are passed through to the shareholders based on their effective interest in the LTC (subject to a limitation rule)
7. all shareholders must elect for the company to become an LTC
8. on a breach of eligibility or a shareholder revocation the company is taxed as an ordinary company.

The advantages of **Becoming an LTC** include:

1. continuation of limited liability
2. profits taxed at the personal tax rates
3. access to losses (subject to the limitation rule)
4. can transition from QC/LAQC with no tax cost
5. less compliance cost than a limited partnership
6. no conveyancing costs or mortgage break fees
7. no effective change in structure meaning rights, obligations and image continue

The disadvantages of **Becoming an LTC** include:

1. the need to ensure that eligibility is maintained
2. salaries paid to working shareholders only deductible if there is an employment contract
3. FBT issues for working shareholders remain
4. changes in shareholding can trigger tax consequences

To transition to a sole trader a QC/LAQC can only have one shareholder and any transition to a partnership must occur in proportion to shareholding. As any changes to shareholding of an LTC after the beginning of the 2012 tax year can trigger tax consequences it may be wise to alter the shareholding of a QC/LAQC before 31 March 2011 if the QC/LAQC is to transition to another entity or become an LTC.

In particular, a QC/LAQC cannot choose to transition into a trust. Trustees should then consider whether QC/LAQC shares they own should be distributed to beneficiaries before 31 March 2011.

Where the sole trader, partnership or limited partnership options are chosen all legal work must be completed by balance date 2012 (or 2013) otherwise there will be negative consequences.