

Changes to Qualifying Companies and Loss Attributing Qualifying Companies

In another move targeted at removing inconsistencies in the current tax system, the Government announced changes to the tax treatment of Qualifying Companies, including Loss Attributing Qualifying Companies (LAQC's).

The qualifying Company regime is a concessionary regime for closely held companies. On election to be a qualifying Company, shareholders agree to be personally liable for their share of the Company's income tax liability. The Company is then taxed at 30% on any profits but dividends are taxable only to the extent imputation credits are available.

This allows Qualifying Companies to distribute capital gains tax free. Certain Qualifying Companies can elect to be LAQCs. LAQCs can allocate net losses to shareholders, allowing shareholders to offset losses against their other income.

The LAQC rules have become increasingly attractive in recent years due to the large differential between the Company tax rate (30%) and the top marginal tax rate (38%). Under current rules shareholders in LAQC's have been able to deduct losses at their marginal tax rate but have their profits taxed at the 30% tax rate. This has attracted growing numbers into the regimes. In order to combat this issue, from 1 April 2011 all Qualifying Companies will become "flow-through" entities for tax purposes. As a result, a Company's income and losses would both be passed on to shareholders, so income would be taxed and losses deducted at a shareholder's marginal tax rate.

In an issues paper released following the Budget, Officials set out how this change will be implemented. For income years beginning on or after 1 April 2011, existing Qualifying Companies will be excluded from the definition of "Company" in the Income Tax Act and included in the definition of "Partnership". As a result, the Partnership rules will apply to Qualifying Companies, while the Company rules will not. This means:

- Income and losses will flow through to partners in proportion to their interest in the Qualifying Company.
- The dividend and imputation rules will no longer apply.
- Shareholders will be subject to the special disposal rules in the Partnership rules on the disposal of their shares.
- A loss limitation rule will be imposed. Losses will be able to be claimed by a shareholder in a Qualifying Company, but the amount will be limited to the value of that person's investment in the Qualifying Company. Excess losses may be carried forward and utilised when the shareholder's investment in the Company increases.
- A Qualifying Company will file a Partnership Tax Return, not a Company Tax Return, and the shareholders will include any allocated income and expenses from the qualifying Company in their individual Income Tax Return.

What this change means is that Qualifying Companies (QC) and Loss Attributing Qualifying Companies (LAQC's) are no longer an attractive structure option. We recommend a review of your Company structure and revocation (opt out) of the regime may be required.

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