SERVICES-RELATED PAYMENTS: RESTRICTIVE COVENANTS AND EXIT INDUCEMENTS

Contents

Introduction

1. This issues paper explains why certain services-related payments represent a risk to the tax base. It also contains details of proposed legislative solutions. In line with the generic tax policy process, submissions are invited on these proposals.

2. The New Zealand tax system generally maintains a capital-revenue boundary: income from capital receipts is generally not taxed whereas other income is taxed. Boundaries in the tax system give scope for income that may lie on one side of the boundary to be legally recharacterised to lie on the other side of the boundary.

3. This boundary becomes problematic in the context of services-related payments. Payments that would generally be taxable in the same manner as wages and salary may easily be characterised as non-taxable capital payments. As such there is a risk to the personal services income tax base.

4. There are two components to the services-related payments problem. The identified problem areas are "restrictive covenant" and "exit inducement" payments. A restrictive covenant payment is the consideration given for a restriction on a person's ability to perform services. An exit inducement payment is the consideration given by a prospective employer or contractor to a person to give up a particular status or position.

5. These payments are treated as capital receipts and are, therefore, non-taxable in the hands of recipients. The risk to the tax base results from the potential for these non-taxable capital receipts to be substituted for taxable personal services income.[1] Such arrangements have been increasing in recent years and are likely to continue to increase as a result of the new 39% income tax rate. There is an associated risk to the integrity of the tax system in that the payment of large, tax-free amounts to some individuals may give rise to the perception that the tax system is unfair, which would undermine voluntary compliance.

6. The revenue risk posed by these payments is reduced but not removed if the payments are not deductible to the payer. This is because the non-taxation/non-deductibility of the payments can still produce a more attractive result for both payers and recipients in some situations than if the payments were taxable and deductible. For instance, if the payer (typically a company) is on a 33% rate and the recipient is on the new 39% personal income tax rate, the payer sacrifices a deduction at the rate of 33% but the recipient escapes taxation at the rate of 39%. Also, if the payer is a tax-exempt entity or has tax losses, any deduction is of less value to these entities than to a tax-paying entity. For these reasons, making the payments non-deductible would not be sufficient to protect the tax base.

[1] Personal services income includes payments made under both contracts of service (employment contracts) and contracts for services. It also includes payments made to office holders. References in this paper to "services" or "personal services" generally include employment, and being an independent contractor and office holder. Also, examples of employment situations in this paper generally include independent contracting and office holding.

7. The Committee of Experts on Tax Compliance (1998) reviewed the treatment of restrictive covenant and exit inducement payments and recommended that the Government consider legislation to make them taxable.

8. This issues paper proposes making these types of services-related payment taxable. A number of associated amendments concerning deductibility and timing matters are also proposed.

9. It is proposed that amendments addressing the revenue risk posed by these services-related payments should be included in the next tax bill to be introduced in Parliament, with application from the date of enactment.

Submissions

10. Submissions are invited on the proposals in this issues paper. In particular, the Government wishes to receive submissions that deal with issues such as:

- The scope of the proposed provision for taxing restrictive covenant payments.
- The proposal not to exclude restrictive covenant payments on the sale of a business.
- The scope of the proposed provision for taxing exit inducement payments.
- The proposal that special legislative provision be made to ensure that restrictive covenant and exit inducement payments can be deducted.

Submissions may be made in electronic form to:

policy.webmaster@ird.govt.nz

Alternatively, submissions can be addressed to:

Services-related payments
c/o General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Submissions should contain a brief summary of their main points and recommendations. They should be made by 31 July 2000.

Restrictive covenant payments

11. A restrictive covenant payment is the consideration given for a restriction on a person's ability to perform services. This part of the paper explains why this type of services-related payment represents a risk to the tax base, and proposes a legislative solution which involves making these payments taxable.

Problem

12. The New Zealand courts have held that payments for restrictive covenants are non-taxable capital receipts. In the cases of *Henwood*[2] and *Fraser*[3], the taxpayers each received payment for acting or advertising services in relation to a particular product and a payment for an agreement that restrained them from endorsing any other similar product during the contract term. The taxpayers treated the restrictive covenant payments as capital receipts and, therefore, as not taxable. In both cases the Court of Appeal upheld that treatment.

13. Payments under personal services contracts can be highly sensitive to tax considerations. Once a total fee for a contract has been agreed, the apportionment of receipts between taxable services and a non-taxable restrictive covenant can be quite flexible. There is currently no guideline on how to apportion the amount paid under a personal services contract to a restrictive covenant, and this can result in a high proportion of a total payment being characterised as a non-taxable capital receipt. For example, in the *Henwood* case, 88% of the total remuneration was referable to the restrictive covenant.

14. When there is flexibility regarding the apportionment of receipts between taxable and non-taxable elements of a personal services contract, taxpayers are well placed to maximise non-taxable restrictive covenant receipts and minimise their taxable personal services receipts.

15. Restrictive covenant payments occur frequently in the entertainment, sports and advertising industries. The concern is that the use of restrictive covenants will increase over a wide range of industries, thereby reducing the standard wage and salary tax base. This trend is already apparent at the high end of the remuneration range, and will be accelerated by the new 39% rate.

16. Restrictive covenant payments can be made more than once over the duration of a personal services contract (this cannot be done with exit inducement payments). This length of time over which restrictive covenant payments can be substituted for taxable income from services increases the associated revenue risk.

[2] *Commissioner of Inland Revenue v Henwood* (1995) 17 NZTC 12,271.
[3] *Commissioner of Inland Revenue v Fraser* (1996) 17 NZTC 12,607.

17. The Court of Appeal held in *Buckley & Young*[4] that restrictive covenant payments are generally non-deductible capital payments. Therefore the actual revenue loss from this payment type should be limited to the extent to which the payer and the payee are on 33% and 39% income tax rates respectively and tax-loss or tax-exempt entities make the payments.

18. In summary, there is clearly an ability for non-taxable restrictive covenant payments to be substituted for taxable personal services income. A legislative solution is, therefore, desirable to address the revenue risk posed by these payments.

Proposed solution

19. It is proposed to make restrictive covenant payments taxable under the Income Tax Act 1994. This follows the recommendation of the Committee of Experts on Tax Compliance (1998) that the Government consider legislation to make restrictive covenant payments taxable.

20. The solution proposed in this paper is based on United Kingdom legislation[5] – which taxes restrictive covenant payments to employees and office holders – but has been modified to apply also to independent contractors. The proposed solution would provide that if a person gives an undertaking which has the effect of restricting the person's ability to perform as an employee, office holder or independent contractor, any payment to that person or any other person in respect of the undertaking is taxable to that person.

21. A possible form of legislation for making restrictive covenant payments taxable would be[6]:

> *If a person gives an undertaking the tenor or effect of which is to restrict the ability of the person to perform as an employee, office holder or independent contractor, any payment or benefit to the person or any other person in respect of the undertaking is gross income of the person.*

22. This solution is quite broad in that the contract to provide services and the restrictive covenant contract can be with different persons. It should cover any combination of payment and agreement between multiple entities by focusing on the restrictive covenant payment itself.[7]

23. The solution does not, however, address the situation of an employee making a restrictive covenant agreement with a wholly-owned company, the shares in which the employee subsequently sells to his or her employer. The amount received by the employee for the sale of shares may be treated as a non-taxable capital receipt. This arrangement would be enough to break the link between the employment relationship and the restrictive covenant. A specific anti-avoidance rule would be required to ensure that a payment received under such an arrangement would be taxable.

---

[4] *Commissioner of Inland Revenue v Buckley & Young* (1978) 2 NZLR 485.
[5] Section 313 of the Income and Corporation Taxes Act 1988 (UK). Under this provision payments made under restrictive covenant agreements relating to employees or office holders are treated as taxable emoluments from employment. This provides a model for legislative inclusion of these payments in taxable income in New Zealand.
[6] This draft will be reviewed as submissions are received and after further consideration.
[7] This would include, for example, the arrangement in the *Fraser* case, in which four entities were involved in the transaction.

24. This specific anti-avoidance rule would be a backstop to the primary provision making restrictive covenant payments taxable. It would clarify that payments in the circumstances described are to be taxed. The inclusion of a specific anti-avoidance rule would not preclude the application of the general anti-avoidance provision.

25. Restrictive covenant payments should be brought within the "source deduction payment" definition (the PAYE rules) to ensure withholding at source.

Restrictive covenant payment on sale of a business

26. An issue arising from the proposal to tax restrictive covenant payments is whether a restrictive covenant payment associated with the sale of a business should be taxed. Restrictive covenants are commonly given to preserve the goodwill being transferred on the sale of the business. Payment for the restrictive covenant is sometimes incorporated in a single payment for goodwill.

27. It is proposed that the reform to tax restrictive covenant payments should not exclude restrictive covenant payments on the sale of a business. Submissions are welcome on this aspect of the proposed reform, especially on the implications for the tax treatment of goodwill payments and any compliance cost difficulties taxpayers would face in valuing restrictive covenants connected with the sale of a business.

Exit inducement payments

28. An exit inducement payment is the consideration given by a prospective employer or contractor to a person to give up a particular status or position. This part explains why this type of services-related payment represents a risk to the tax base, and proposes a legislative solution which involves making these payments taxable.

Problem

29. The New Zealand courts have held that exit inducement payments are non-taxable capital receipts. In *Fraser*,[8] the taxpayer received a payment to induce him to leave his former profession and to enter into the advertising contract. The taxpayer treated this exit inducement payment as a capital receipt and, therefore, non-taxable. The Court of Appeal upheld that treatment on the basis that the taxpayer had given up his career as a current affairs presenter to enter into the advertising contract.

[8] *Commissioner of Inland Revenue v Fraser* (1996) 17 NZTC 12,607.

30. A more recent court decision is *Case U8*.[9] That case held that "loss of status" does not require a significant change of profession, and thus lowers the hurdle that must be surmounted for a payment to be considered non-taxable. In *Case U8*, the taxpayer was paid an inducement to leave a large finance company and to take up an appointment with a smaller finance company. The taxpayer treated this inducement payment as a capital receipt and, therefore, as not taxable. The Taxation Review Authority upheld that treatment, deciding that the payment was not an advance payment for performing services for the new employer but rather was compensation for a change of status in leaving the security of a large corporation.

31. The exit inducement decisions in *Fraser* and *Case U8* provide scope for substituting non-taxable capital receipts for taxable income from services. Exit inducement payments are starting to be regularly made, especially in the professional services area. It seems that these payments are being received by people as an incentive to change the firm for which they are working within the same occupational area. This incentive has increased with the new top personal income tax rate of 39%.

32. It is uncertain whether exit inducement payments are deductible to the payer. There is no New Zealand case law that holds that exit inducement payments are deductible or non-deductible. Inland Revenue has not issued any policy statements on the deductibility of these payments.

33. Two factors limit the use of exit inducement payments and, therefore, the potential revenue loss. First, exit inducement payments can only be made at the beginning of an employment relationship. Second, payers may also be reluctant to offer these payments because they are non-refundable if the recipient leaves early or does not begin the new employment.

34. The non-taxable nature of exit inducement payments, however, combined with uncertainty as to the deductibility of these payments, means that there is a risk to the tax base. And regardless of the deductibility of exit inducement payments, there is a revenue risk to the extent that the payer and recipient are on 33% and 39% income tax rates respectively and tax-loss or tax-exempt entities make the payments. They allow otherwise taxable income from services to be replaced with non-taxable receipts. A legislative solution is, therefore, desirable to address the revenue risk posed by these payments.

Proposed solution

35. It is proposed that exit inducement payments be made taxable. This follows the recommendation of the Committee of Experts on Tax Compliance (1998) that the Government consider legislation to make exit inducement payments taxable. A specific charging provision could be inserted in the Income Tax Act 1994 to this end. The proposed provision would tax any compensation for loss of a vocation, position or status or any payment for leaving a position.

[9] *Case U8* (1999) 19 NZTC 9,068.

36. A possible form of legislation for making exit inducement payments taxable would be[10]:

Any payment, compensation or benefit derived by a person in connection with a loss of a vocation, position or status or for leaving a position is gross income of that person.

37. The proposed solution would cover an exit inducement payment made to compensate the payee for leaving a contract of employment. The drafting is also broad enough to cover the situation where the position being vacated is not an employment one – for example, an independent contractor position or an office such as a board membership. The exit inducement cases of *Vaughan-Neil*[11] and *Pritchard v Arundale*[12] involved a barrister and a partner in a firm of chartered accountants respectively, both being a position where the payee was a non-employee. The *Fraser* and *Case U8* cases involved taxpayers leaving employment situations.

38. The solution focuses on payments for vacating a position. This is consistent with the nature of an exit inducement payment as compensation for giving something up in the course of starting a new position. It is not necessary for the provision to apply to inducements to take up a position because these are generally taxable as monetary remuneration to an employee or business income to an independent contractor.

39. The proposed provision would need to address a case like *Fraser*, where the emphasis in the judgments was that the taxpayer was being compensated for the loss of his career as a television presenter, as well as the traditional type of exit inducement case which involves a loss of status.[13] The provision would also need to encompass situations such as that in *Case U8*, which represents an extension over previous exit inducement cases. That situation does not involve a distinct change of career or loss of social status, but only a change of employment or position within the same industry. It is necessary, therefore, to include within the proposed charging provision compensation for a simple loss of a particular contract of services or contract for services.

40. The charging provision would need to be sufficiently broad to cover in-kind consideration such as an exit inducement which involved the transfer of shares to the recipient, not just monetary payments.[14]

41. Exit inducement payments should be included in the "source deduction payment" definition (the PAYE rules) to ensure withholding at source.

Deductibility and timing issues

42. This part of the paper deals with deductibility and timing issues arising from making restrictive covenant and exit inducement payments taxable. A number of associated amendments are proposed.

[10] This draft will be reviewed as submissions are received and after further consideration.
[11] *Vaughan-Neil v Inland Revenue Commissioners* (1979) STC 644.
[12] *Pritchard v Arundale* (1971) 47 TC 680.
[13] For example, *Jarrold v Boustead* (1964) 41 TC 701, *Pritchard v Arundale* and *Vaughan-Neil v Inland Revenue Commissioners.*
[14] *Pritchard v Arundale* involved the transfer of shares to the taxpayer.

Deductibility of services-related payments

43. Restrictive covenant payments are generally non-deductible capital expenditure. If these payments become taxable they should also be able to be deducted by the payer over the term of the restrictive covenant. This will ensure consistency with the treatment of salary and wages and other payments for services. Because case law establishes that restrictive covenant payments are generally non-deductible, it will be necessary to make special legislative provision to ensure that these payments can be deducted.

44. There is no New Zealand case law that explicitly states whether exit inducement payments are or are not deductible to the payer. Moreover, Inland Revenue has not issued any public rulings or policy statements on the deductibility of these payments. However, if these payments become taxable, special legislative provision should be made to ensure deductibility. Again, such treatment would provide consistency with the treatment of salary and wages and other payments for services.

45. A special provision for the deductibility of restrictive covenant payments and exit inducement payments could follow the model of providing express relief from the exclusion for capital expenditure, which is used in other places in the income tax legislation, such as section DJ 13. This means that it will still be necessary for a payment to have the necessary connection with gross income as required by the general deductibility rule in section BD 2(1)(b)(i) and (ii).

46. A final issue is that an unqualified provision for deductibility of restrictive covenant and exit inducement payments would introduce an inconsistency with the treatment of wages and salary. This is because wages and salary are non-deductible capital expenditure to the extent that they relate to work of a capital nature undertaken by recipient employees, as in *Christchurch Press Company Ltd*[15]. If outright relief from the exclusion for capital expenditure were provided, restrictive covenant and exit inducement payments could never be characterised as capital expenditure, even when the work is of a capital nature. Employers could, therefore, prefer to make these payments instead of wage and salary payments if capital works are involved.

47. To prevent such different treatment, it is proposed that restrictive covenant and exit inducement payments be deductible in the same circumstances as salary and wages.

Timing of income and expenditure

48. It is envisaged that the ordinary tax accounting principles and provisions of the Income Tax Act 1994 will apply to determine the time at which services-related payments are included in gross income or allowed as a deduction. No special legislation should be needed. The particular tax accounting principles that apply will depend on the type of taxpayer.

[15] *Christchurch Press Company Ltd v Commissioner of Inland Revenue* (1993) 15 NZTC 10,206.

49. In the case of cash method taxpayers derivation of income is based on the actual receipt of income. So if a payment for a restrictive covenant with a three-year term is paid to an employee as a lump sum in year one, the entire amount is derived and, therefore, taxed in that year of receipt.

50. This treatment may result in some cash method taxpayers being shifted into a higher marginal tax bracket. This already occurs, however, when these taxpayers are paid lump-sum bonuses. Moreover, there is no cash flow problem because the tax liability only arises once the payment has been received. Accordingly, special provision should not be made to spread the payment.

51. A specific amendment will be necessary to allow a deduction to employees who have been taxed up-front on a lump-sum payment received for a restrictive covenant, if they have to repay a portion of the payment because they do not comply with the covenant for its full term.[16]

52. In the case of a taxpayer carrying on a business, the accrual or earnings method applies to determine when an amount is derived. This method is based on the right to receive income (an entitlement to bill) rather than actual receipt.[17] An up-front restrictive covenant payment received by an independent contractor could be spread over the term of the covenant.

53. The ordinary statutory rules will apply to determine the timing of deductibility of these services-related payments. In particular, section EF 1 effectively requires a deduction for expenditure to be spread over the term to which the expenditure relates.[18] For example, in respect of an up-front $30,000 payment made under a restrictive covenant agreement with a three-year term, the allowable deduction for each of the three years would be $10,000.

54. In the case of exit inducement payments, payment is likely to be deducted in full in the year of payment. That is because the statutory criteria in section EF 1 requiring expenditure to be spread over the contract term would not be applicable.[19] There is usually no enduring aspect to an exit inducement beyond the requirement that the payee start a service relationship.

---

[16] A model for such a provision is section DJ 18, which allows a person who has been taxed on the proceeds of crime under section CD 6 a deduction for any restitution made.

[17] *Arthur Murray v Commissioner of Taxes* (1965) 114 CIR 314.

[18] Section BD 4 of the core provisions governs the timing of allowable deductions. Section BD 4(2) provides that if an allowable deduction is subject to a timing regime, the deduction must be allocated to an income year in accordance with that regime. "Timing regime" is defined in section OB 1 to include a regime for allocating allowable deductions to an income year other than the income year to which the allowable deduction would have been allocated in the absence of the regime. In the absence of a timing regime, the payments under a restrictive covenant agreement with a three-year term would be incurred in year one when the agreement is entered into and therefore would have been deductible in that year. However, the timing regime in section EF 1, relating to "accrual expenditure", would require the expenditure on the restraint to be spread over its three-year term. "Accrual expenditure" is defined very broadly in section OB 1 to mean any expenditure that is allowed as a deduction other than expenditure covered by other specific timing regimes, such as the trading stock or accrual rules. Section EF 1(5)(d), applying to choses in action, would be used to determine the unexpired portion of any amount of accrual expenditure relating to restrictive covenants that would need to be added back into the recipient's income, by reference to the unexpired part of the period in relation to which the restraint is enforceable. This mechanism achieves the spread of income.

[19] Once the payment is made there is generally no unexpired portion to be added back to income in future years in terms of section EF 1.

Legislative timetable and application date

55. It is proposed that amendments addressing the services-related payments problem should be included in the next tax bill to be introduced in Parliament, with application from the date of enactment.