

Dividend integrity and personal services income attribution

A Government discussion document



Te Kāwanatanga o Aotearoa
New Zealand Government

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Dividend integrity and personal services income attribution – a Government discussion document

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CHAPTER 1

Introduction

Summary

The Government recently introduced and implemented a new top personal income tax rate of 39% for income earned over \$180,000. Tax rates on other types of taxpayers, including companies and trusts, remain unchanged at 28% and 33% respectively.

The motivation for this reform was to raise extra revenue in a way that is progressive and does as little as possible to increase taxes on low to middle income earners. The integrity measures proposed in this discussion document are intended to support this objective by limiting the ability of individuals to avoid the top 39% rate (or the second-highest personal income tax rate of 33%) by diverting their income through entities taxed at a lower rate.

The Government's work on integrity measures to support the 39% personal income tax rate is being progressed in tranches. Tranche one, which is the focus of this discussion document, concerns dividend integrity and income attribution measures. Tranches two and three will consider trust integrity and company income retention issues and integrity issues with the taxation of portfolio investment income.

This discussion document proposes:

- That any sale of shares in a company by the controlling shareholder be treated as giving rise to a dividend to the shareholder to the extent that the company (and its subsidiaries) has retained earnings.
- That companies be required, on a prospective basis, to maintain a record of their available subscribed capital and net capital gains, so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation.
- That the "80 percent one buyer" test for the personal services attribution rule be removed.

The closing date for submissions on the proposals in this discussion document is 29 April 2022.

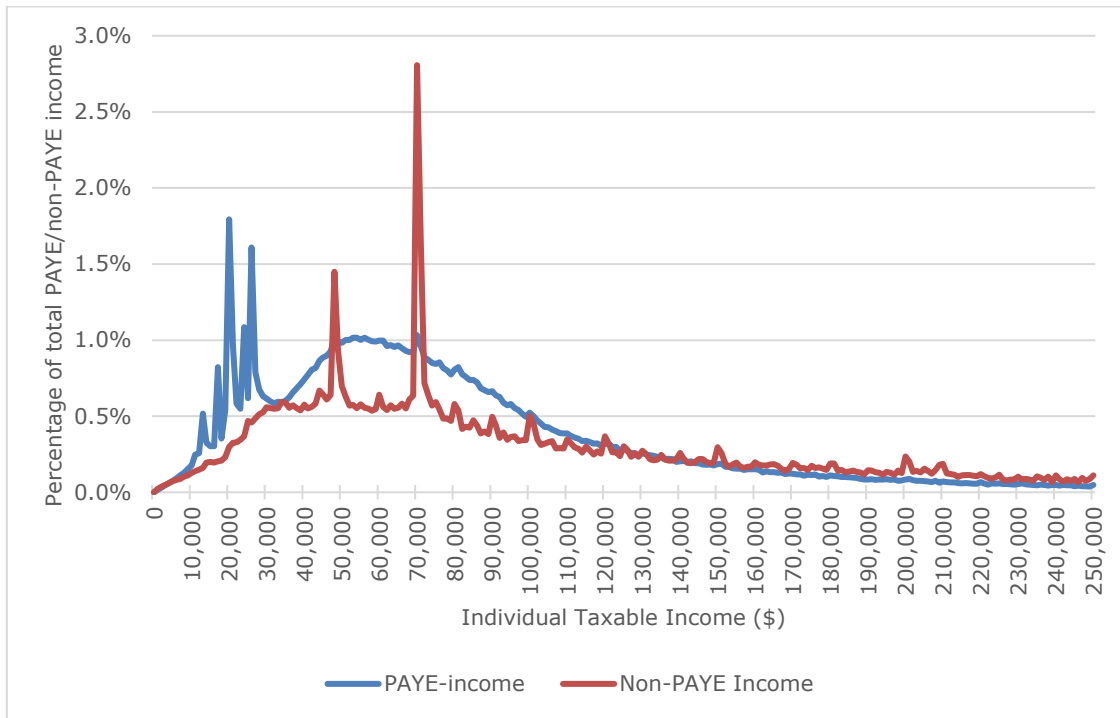
- 1.1 The New Zealand economy is faring relatively well despite the economic disruption caused by the COVID-19 pandemic. However, the ability to continue to face the challenges of COVID-19 and to rebuild the economy will in large part depend on a strong tax base. To continue to be able to provide much-needed support to individuals and businesses, it is crucial that tax revenues remain strong and stable. The Government's objective is to ensure the continuity of revenue streams by ensuring that the tax system is a fair and progressive one, and that everyone pays their fair share of tax.
- 1.2 To this end, the Government introduced a new top personal tax rate of 39% for income earned over \$180,000. For this and other tax rates to be effective, it is important that suitable integrity measures are in place to ensure the tax rules are not circumvented.

- 1.3 The level of taxes paid on income from an investment or activity can vary depending on the entity structure used. There are many good reasons for the use of entities, such as companies and trusts. However, using companies means high income taxpayers can sometimes reduce the amount of their income that is subject to either the 33% personal income tax rate or the new 39% top personal income tax rate.
- 1.4 Potential adverse integrity impacts arising from taxpayers structuring to avoid the 33% and 39% rates include reduced tax revenue, as well as a negative impact on voluntary compliance if taxpayers perceive that avoidance is widespread.
- 1.5 Some of the integrity impacts arise from a difference between the top personal tax rate and the company tax rate. Even with a top personal tax rate of 39%, the gap between the company tax rate and the top personal rate of 11 percentage points is smaller than the gap in most OECD countries. However, New Zealand is particularly vulnerable to a gap between the company tax rate and the top personal tax rate because of the absence of a general tax on capital gains.
- 1.6 There will always be an arbitrage incentive unless the company and personal tax rates are aligned. However, alignment of company and personal tax rates is not the norm internationally. The arbitrage incentive could instead be addressed by increasing the company rate to the level of the top personal rate, but this is not desirable for economic reasons. For this reason, integrity measures are needed.
- 1.7 The biggest area of concern relates to closely-held companies and trusts that are used to earn income on behalf of relatively high income individuals, particularly those who earn income that is taxed at the top personal tax rate of 39% (or who would have income taxed at the top personal rate if they earned the income directly rather than through an entity).
- 1.8 There is much less concern with widely-held and listed companies. This is because they are not under the control of an individual, and so generally cannot be used as a conduit to achieve a lower tax rate on what is really the individual's own income.
- 1.9 The scale of the tax benefit for 33% marginal rate taxpayers is significantly smaller than for taxpayers on the top rate of 39% (a differential of five percentage points versus 11 percentage points). Individuals on the 33% personal tax rate also typically have less total income to divert through other entities than individuals on the top rate, and hence the integrity concerns in relation to the latter group are greater. While the Government's main concern is the integrity of the 39% tax rate, the proposals in this document can affect taxpayers at any personal tax rate in situations where some of or all their income is being earned through entities.

Problem

- 1.10 The bunching of self-employed people at the tax thresholds in Figure 1 suggests that structures may be currently used by some taxpayers to avoid the 33% rate, although bunching at the \$180,000 threshold for the 39% rate is not evident.

Figure 1: Taxable income distribution: PAYE and non-PAYE income (year ended 31 March 2020)



- 1.11 Inland Revenue analysed existing data it holds on 350 high wealth individuals (individuals and families with more than \$50 million in net assets) and found that they used or controlled 8,468 companies and 1,867 trusts.¹ For 2018, these 350 individuals paid \$26 million in tax, while their companies and trusts paid \$639 million and \$102 million respectively, showing a significant amount of income earned through lower tax rate entities.
- 1.12 The Government considers that the current tax settings will lead to further integrity pressures. Evidence to support that expectation comes from the increased avoidance of the top personal tax rate that occurred in 2000 in response to the increase in the top personal rate to 39%.
- 1.13 Increased structuring may have unintended impacts on:
- Revenue: Tax collected is reduced by increased structuring activity. This is due to the direct impact of taxpayers being able to earn their income through lower-taxed entities, such as trusts and companies. It is also because an inconsistent rate structure makes it harder for courts to find tax avoidance when the different rates mean it is difficult to determine whether a structure undermines what Parliament contemplated.
 - Social capital and the integrity of the tax system: Perceptions of arbitrary outcomes, such as when some taxpayers can structure to avoid the 39% rate, will erode public confidence in the integrity of the tax system and the perception that all taxpayers are treated fairly.
 - Horizontal and vertical equity: In the absence of integrity measures, more income of high-wealth individuals and others with substantial capital income is likely to flow to lighter-taxed entities. This suggests that the impact of the 39% personal tax rate will disproportionately fall on less wealthy salary and wage earners.

¹ This analysis on high wealth individuals was undertaken separately from the High Wealth Individuals Research Project and is less comprehensive.

- 1.14 In light of these integrity risks, the Government is reviewing the current settings to see if changes are required, particularly to support the integrity of the new top personal tax rate of 39%.

Scope of review

- 1.15 Work in this area will focus on improving the integrity of the rules relating to sales of shares and the attribution of income from personal services. It will also consider how to improve the integrity of trust and company income retention rules.
- 1.16 The review of the current settings is being progressed in tranches. Tranche one, which is the focus of this discussion document, concerns dividend integrity and income attribution measures relating to the use of closely-held companies and trusts by high income individuals.
- 1.17 The policy options considered in this document for tranche one would not attribute all income earned through companies and trusts to individuals and tax it at their individual personal tax rates. However, they would create the potential for a significant amount of income (a large proportion of which is derived by comparatively few families and individuals) to be recharacterised and taxed at the appropriate rate.
- 1.18 Tranche two will consider trust integrity and company income retention issues. Inland Revenue will be receiving more specific information from trustees for the 2021–22 and later income years under provisions in the recently enacted amendments to the personal income tax rate legislation. This additional information could help to inform in more detail how trusts are used and what measures could be considered to prevent under-taxation from the use of trusts.
- 1.19 Income retention measures would address the current situation where taxpayers can achieve a deferral of tax by investing through a company (including in cases where eventual distributions are taxed at the 39% rate).
- 1.20 A possible tranche three could consider integrity issues for the taxation of portfolio investment income, such as Portfolio Investment Entity (PIE) taxation. However, given that PIEs are used by large numbers of low- and middle-income New Zealanders, and their taxation is a component of savings policy as well as tax policy, this is not as urgent a concern as the tranche one and tranche two issues.
- 1.21 The motivation for the recent introduction of the 39% top personal income tax rate was to raise extra revenue in a way that is progressive and does not increase the tax burden on low to middle income earners. The Government intends that any legislative measures arising from the review of the integrity of the 39% rate will be broadly consistent with this objective and with current tax policy settings.
- 1.22 The current tax policy settings are a top personal income tax rate of 39%, a 28% company tax rate, a 33% trustee rate (pending the upcoming review as part of tranche two of the use of trusts to avoid the top personal tax rate) and no general capital gains tax. The integrity measures proposed in this discussion document are consistent with these broader settings. This document does not consider options such as aligning the top personal income tax rate with the company and trustee rates or introducing a capital gains tax. Rather, the measures proposed focus on mechanisms that divert the income of a taxpayer on the 33% or 39% rate through channels that allow it to be taxed at a lower rate.

Dividend integrity

- 1.23 This document firstly considers two issues with the current law and practice regarding income of companies received by shareholders. Distributions from companies are intended to be taxable income to the shareholders (dividends), unless excluded because they are either returns of contributed capital or a distribution on liquidation of net capital gains. Under the imputation system, taxable distributions from New Zealand companies can carry with them a credit for New Zealand income tax paid by the company. However, because the corporate tax rate is lower than the top personal tax rate and the trustee rate, there is often a residual tax liability for the shareholder (or the paying company, where RWT is imposed).
- 1.24 Current law and practice offer a number of routes for shareholders to directly or indirectly realise cash (or other property) relating to earnings of a company without triggering any tax liability. The first issue considered in this document is sales of shares. A sale of shares offers an alternative way for a shareholder to realise cash, often but not always representing the earnings or capital gains of the company, with no, or a substantially deferred, tax cost.
- 1.25 When a company is sold, the purchaser's payment to the vendor includes the value of assets funded by retained earnings. Under current law, this payment is generally on capital account. Because a change of ownership will eliminate imputation credits, any subsequent distribution of the retained earnings will be taxable to the purchaser. However, if the purchaser adopts the simple expedient of acquiring 100 percent of the target using a holding company, this taxation is permanently eliminated by the inter-corporate dividend exemption.
- 1.26 Secondly, practical issues arise when a company cancels shares or is liquidated. At this point, the company's available subscribed capital (ASC)² and (in the case of a liquidation) net capital gains need to be determined, in order to determine the amount of the dividend on liquidation. However, there is currently no requirement for a company to have kept any record of these amounts during its life. This can make accurately determining the amount of a dividend on share cancellation or liquidation highly problematic.

Personal services attribution

- 1.27 This document also considers the scope of the personal services attribution rule and whether it may need to be expanded in light of recent developments such as the introduction of the new top personal tax rate of 39%. The personal services attribution rule applies in certain circumstances when income from "personal services" performed by an individual is earned through an entity, such as a company or a trust. The rule attributes the income from personal services to the individual who performs the services, thereby ensuring the income is taxed at the individual's marginal rate of personal income tax, rather than at the company rate of 28% or the trustee rate of 33%.
- 1.28 There is a risk that taxpayers on the 39% personal tax rate will use trusts and companies to obtain a lower tax rate on what is in fact personal services income. This is an issue both for taxpayers providing personal services to a single customer and taxpayers providing personal services to multiple customers. In each case, the economic reality is that the taxpayer is performing work and being paid for it – the entity is a conduit for the taxpayer's income-earning

² "Available subscribed capital" refers to a company's paid-up share capital and can be distributed tax free to shareholders on liquidation.

activity. Consequently, the taxpayer should be taxed on their personal services income at the applicable marginal rate. However, currently, the legal structure used allows tax to be paid at a lower rate.

Proposed solutions

1.29 This discussion document suggests a number of ways to address these issues and improve the integrity of the 39% personal tax rate and the dividend definition. In particular, it proposes:

- That any sale of shares in a company by the controlling shareholder be treated as giving rise to a dividend to the shareholder to the extent that the company (and its subsidiaries) has retained earnings. This will trigger a residual tax liability for the shareholder. The company should also have an increase in its ASC. This ASC increase will address a current inequity in the imputation credit continuity rules and prevent double taxation upon liquidation.
- That companies be required, on a prospective basis, to maintain a record of their ASC and net capital gains, so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation. These accounts would be similar to the imputation credit accounts already required to be kept but would have fewer entries.
- That the "80 percent one buyer" test for the personal services attribution rule (that is, at least 80 percent of the associated entity's income from personal services during the income year is derived from the supply of services to one buyer in particular and/or an associate of the buyer) be removed.

1.30 This discussion document also poses the following questions in relation to the personal services attribution rule:

- Should the 80 percent threshold for the "80 percent one natural person supplier" test (that is, at least 80 percent of the associated entity's income from personal services is derived from services that are performed by the working person and/or a relative of theirs) be reduced to 50 percent?
- At what level should the threshold for the substantial business assets test (currently the lower of \$75,000 or 25% of the associated entity's income from personal services for the income year) be set?

Making a submission

1.31 The Government invites submissions on the proposals in this document, including the specific questions asked and any other issues raised in the document.

1.32 Include in your submission a brief summary of the major points and recommendations you have made. Please indicate if officials from Inland Revenue can contact you to discuss the points raised, if required.

1.33 The closing date for submissions is **29 April 2022**.

1.34 Submissions can be made:

- by email to policy.webmaster@ird.govt.nz with "Dividend integrity and person services income attribution" in the subject line, or

- by post to:

Dividend integrity and personal services income attribution
C/- Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
PO Box 2198
Wellington 6140

- 1.35 Submissions may be the subject of a request under the Official Information Act 1982, which will result in their publication unless there are grounds under that Act for the information to be withheld. Please clearly indicate in your submission if any information should be withheld on the grounds of privacy, or for any other reason (contact information such as an address, email, and phone number for submissions from individuals will be withheld). Any information withheld will be determined using the Official Information Act 1982.

Part I: Sale of shares

CHAPTER 2

Dividend avoidance and share sales

Summary

Tax avoidance involving the sale of shares is often called “dividend stripping.” In broad terms, dividend stripping refers to a situation where a shareholder of a company avoids receiving a taxable dividend by selling their shares for a non-taxable capital sum, often without a change in the economic ownership of the acquired company.³ However, a taxable dividend can also be prevented from arising by way of a commercial share sale with no purpose of avoidance.

This chapter describes the current law relating to dividend stripping and examines the wider international context.

Background

Causes

- 2.1 Where a shareholder owns a company that distributes dividends, there are two main levels of taxation. The first is the taxation of the profits of the company, and the second is the taxation of the income (dividend) of the shareholder. Different countries deal with these two levels of taxation in different ways, through a classical system, an imputation system, or a full integration system.
- 2.2 New Zealand’s imputation system allows shareholders to use imputation credits to offset tax paid by the company against their own personal income tax liability when they receive an imputed dividend. If a shareholder’s marginal tax rate is above the company tax rate, then the shareholder pays a top-up tax so that the profits originally generated by the company have tax paid on them equal to the marginal tax rate of the shareholder. The distribution of the dividend is therefore what triggers the requirement to pay the final amount of tax on the profits earned by the company. However, if a dividend is not distributed, the requirement for that top-up tax to be paid is not triggered.
- 2.3 A dividend is one way a company owner can realise the value generated by the company. Another is for the owner to sell the shares in the company. Under current law, a share sale would not usually trigger any top-up tax, and such transactions are therefore a way for the shareholder to realise the earnings of the company without paying any additional tax.
- 2.4 The degree to which dividend stripping via share sales is a problem depends on the difference between a shareholder’s marginal tax rate and the company tax rate. The increase in the top personal tax rate to 39% without any change to the company tax rate has made this issue more significant.

³In the international context, dividend stripping may also refer to a number of slightly different situations. In Australia, the issue of dividend stripping is more concerned with the purchasing and selling of shares either side of the ex-dividend date. In some countries, dividend stripping refers to the payment of large dividends that reduce the value of shareholders’ stakes in a company, which in turn contributes to generating a lower capital gain/higher capital loss upon disposal of the shares.

- 2.5 There are some broad categories of solutions available to deal with integrity issues around share sales. At the highest level, having perfect alignment between corporate and personal tax rates would negate the need for any top-up tax to be paid and so there would be no tax to avoid. Alternatively, if dividends were generally exempt, this would also negate the need for any top-up tax to be paid. On the issue of share sales, a capital gains tax would also go some way to solving the problem of dividend stripping as some of the proceeds of a share sale would be taxable. However, the Government has already ruled out introducing a capital gains tax, and so neither of these solutions are within the scope of the current proposals.

Current provisions and relevant cases

- 2.6 This section outlines the legislative provisions, interpretative publications, and the principles established from case law that have governed how, and contributed to the way in which, Inland Revenue deals with dividend avoidance arrangements involving the sale of shares.
- 2.7 Dividend stripping arrangements are mostly governed by anti-avoidance legislation. Such legislation can be complex to administer and costly to litigate.

Legislation and interpretations

Anti-avoidance provisions

- 2.8 Dividend stripping arrangements are mostly governed in statute by the general anti-avoidance provisions in section BG 1 (Tax avoidance) as well as the dividend anti-avoidance provisions in section GB 1 (Arrangements involving dividend stripping).
- 2.9 The two sections are clearly linked. Subsection BG 1(1) states that a tax avoidance arrangement is void for income tax purposes, while subsection GB 1(1)(b) conditions the application of the dividend anti-avoidance provisions on the disposal of shares being part of a tax avoidance arrangement. This suggests that a transaction is not a dividend stripping arrangement if it is a genuine sale of a company to a third party since that transaction would not be part of a tax avoidance arrangement, even if it did have the effect of transferring value from the company to the vendor of the company.
- 2.10 If a certain disposal of shares is considered to be a tax avoidance arrangement, the dividend anti-avoidance provisions in section GB 1 apply when some (or all) of the consideration that the person derived from the disposal is in substitution for a dividend. This amount derived in substitution for a dividend is then treated as a dividend of the person and therefore becomes taxable income.
- 2.11 Subsection GB 1(2) states that an amount is in substitution for a dividend if it is equivalent to, or substitutes for, a dividend that a person either would have (or would in all likelihood have) derived or be expected to derive. In circumstances where the question is whether a person would likely have derived or be expected to derive a dividend, this provision is subjective and can lead to inconsistency in self-assessment and application.
- 2.12 Between having to show that an amount of consideration is "in substitution for a dividend", and the requirement to prove that a transaction constitutes a tax avoidance arrangement (that is, there is no genuine commercial rationale for the transaction), it can often be unclear to all parties whether the sale of shares in a given circumstance would be subject to these anti-avoidance provisions.

- 2.13 The inter-corporate dividend exemption⁴ is one of the main mechanisms used to distribute dividends tax free from a target company to its original shareholder. A distribution from the target company to a holding company when both are effectively owned by the same natural person(s) falls under this inter-corporate dividend exemption. The natural person(s) can then extract the dividend through an existing loan arrangement or through a return of equity under the available subscribed capital (ASC) rules.

Interpretation Statement 13/01

- 2.14 In 2013, Inland Revenue released Interpretation Statement IS 13/01 *Tax avoidance and the interpretation of section BG 1 and GA 1 of the Income Tax Act 2007*. This publication canvassed in depth the current anti-avoidance provisions and their interpretation, with specific reference to the judgment in *Ben Nevis*.⁵
- 2.15 Dividend stripping is not explicitly referred to in IS 13/01, but the Statement provides detailed commentary on the concept of tax avoidance generally. These avoidance principles are entirely applicable to dividend stripping arrangements not within Parliament's contemplation.

Revenue Alert 18/01

- 2.16 Following the judgment in *Beacham*,⁶ Inland Revenue issued Revenue Alert RA 18/01 Dividend stripping – some share sales where proceeds are at a high risk of being treated as a dividend for income tax purposes.
- 2.17 RA 18/01 deals exclusively with cases involving related entities where the economic effect of the transaction does not include a substantial change in ownership. This gives some indication of Inland Revenue's focus when investigating cases of dividend stripping under section GB 1 or section BG 1.⁷ The Alert considers that the greater the similarity between the original shareholder's owner before and after the sale of shares in the target company, the higher the likelihood that the arrangement would be regarded as tax avoidance. RA 18/01 gives a number of examples pertaining to restructuring involving trusts, shareholder exits, and mergers.
- 2.18 The Alert focuses on *Beacham* to illustrate the kinds of transactions under scrutiny, but states that the Commissioner of Inland Revenue's view is that sections BG 1 and GB 1 can apply in a wider range of circumstances than in that case.⁸
- 2.19 RA 18/01 notes that Inland Revenue (as of 2018) has begun undertaking investigations into taxpayers who have entered into the sorts of arrangements described in the Alert. Where Inland Revenue considers that some non-taxable transfer of value to a shareholder is in substance a dividend, it will reassess that shareholder on the relevant amount.

⁴ Section CW 10.

⁵ *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289.

⁶ *Beacham v Commissioner of Inland Revenue* [2014] 26 NZTC 21-111.

⁷ RA 18/01 does, however, note that shares in a cashed-up target company sold for the purpose of avoiding tax on a liquidating distribution should be taxed as a dividend rather than be treated as an ordinary share sale.

⁸ Tax avoidance concerns may be raised, for example, when an arrangement creates ASC in a company despite the shareholder not providing anything in economic reality for the issue of shares by that company.

Case law

2.20 The following outlines the criteria that, following case law precedent, are used to determine whether a sale of shares is deemed to be a tax avoidance arrangement.

- Firstly, it should be considered whether the buyer and seller of the shares are associated persons. For example, in the case where the owner of a target company forms another company to purchase shares in the target company, the economic ownership of the target company has not changed, yet the owner will be able to realise some of the value of that company through a capital sum (since they will be associated with the company they formed to purchase the shares). In this case, it is unlikely that there is genuine commercial motivation for the sale.
- Secondly, it should then be considered whether the target company is cashed-up and whether the buyer can liquidate the company by either:
 - making use of the inter-corporate dividend exemption, or
 - taking a deduction if a loss is made upon the buyer's future disposal of the shares.

2.21 Dividend stripping arrangements typically tend to involve some of or all the following:

- Control of the target company is not transferred in the transaction.
- There is no genuine commercial rationale for the sale of shares.
- The buyer bears little or no financial risk in the transaction.
- The arrangement appears to be artificial.

New Zealand context

2.22 During the 1990s, the top personal rate and the corporate rate were both 33% (as well as the trustee rate). This reduced the need for any broader anti-dividend avoidance provisions. Since then, the company tax rate has fallen and the top personal tax rate has increased, so there is now an 11 percentage point difference making the issue more significant.

2.23 Since the first increase in the top personal tax rate to 39% in 2000, New Zealand has seen a notable increase in the imputation credit account (ICA) balances of non-listed companies.⁹ This suggests that smaller or fewer dividends are being paid to shareholders.

International context

2.24 The need that a country has for deemed dividend rules varies according to other tax settings within their country. Some countries do have rules for dealing with the types of dividend stripping outlined here. Those countries also typically have other tax settings that limit taxpayers' ability to engage in types of dividend avoidance, such as capital gains taxes and, to a lesser extent, full integration of company and personal taxes.

⁹ At a high level, the ICA balance of a company represents the tax paid by that company minus the imputation credits attached to dividends the company has distributed to shareholders, as well as refunds received. Subpart OB and subpart OP of the Income Tax Act 2007 set out all the possible ICA adjustments.

- 2.25 Australia has legislation that details what sorts of payments, loans, and debt forgiveness arrangements are treated as dividends. There are also provisions outlining what is not a dividend for tax purposes. A dividend stripping operation is referred to in the legislation but does not have a precise legal meaning. Australian case law has referred to dividend stripping arrangements having some of the following features or characteristics:¹⁰
- A target company with significant undistributed profits.
 - A sale of shares in the target company to another party.
 - A payment of a dividend to that other party out of the target's undistributed profits that is exempt from income tax.¹¹
 - The original shareholders receiving a capital sum for their shares in the target company.
 - The arrangement was carefully planned for the purpose of avoiding tax on the distribution of dividends.
- 2.26 In 2014, the Australian Tax Office (ATO) published a Taxation Determination on dividend access share arrangements.¹² This addressed circumstances where a company issued a new class of shares on which franked dividends were paid. These shares are often sold to a company owned by the original shareholder. The creation of a new class of shares is a variation on the dividend stripping arrangements referred to in this discussion document. The Taxation Determination ruled that a dividend access share arrangement is either a dividend stripping arrangement or is in the nature of dividend stripping.
- 2.27 The ATO also released a Taxpayer Alert in 2015 on dividend stripping arrangements.¹³ This was with reference to the sale of private company shares to a self-managed superannuation fund, though the principles are equivalent to the concerns of dividend stripping in New Zealand (particularly with regard to the issue of the original shareholders avoiding the top-up tax on the dividend income). This issue arises because income from shares that supports the payment of pensions is exempt income of the self-managed superannuation fund. The Taxpayer Alert suggests that if a taxpayer enters into an arrangement with similar features to those described, the ATO may apply one or a combination of the main anti-avoidance provisions, the non-arm's length income provision, and any other relevant compliance provisions.
- 2.28 The Netherlands has specific anti-dividend stripping rules that deny a reduction of withholding tax for dividends or deny a credit for withholding tax paid. To guard against the use of loans in these arrangements, an interest deduction may be denied if a related party grants a loan with respect to distributions of profit, repayments or contributions of capital, or to acquire shares in a company such that the target company becomes a related company after the acquisition.
- 2.29 Japan's previous provisions for exempting inter-corporate dividends also created dividend stripping concerns. For example, a target firm may buy back

¹⁰ These characteristics are referred to in, *Lawrence v Commissioner of Taxation* [2009] FCAFC 29; (2009) 175 FCR 277; (2009) 2009 ATC 20-096; (2009) 75 ATR 306.

¹¹ For example, a dividend paid to a non-resident or if it qualifies for the inter-corporate dividend exemption.

¹² Australian Taxation Office. (2014). *TD 2014/1*. Taxation determination. <https://www.ato.gov.au/law/view/document?DocID=TXD/TD20141/NAT/ATO/00001&PIT=99991231235958>

¹³ Australian Taxation Office. (2015). *TA 2015/1*. Taxpayer alert. <https://www.ato.gov.au/law/view/document?DocID=TPA/TA20151/NAT/ATO/00001>

some of its shares from a corporate shareholder, and the shareholder then sells its remaining shares in the target to a third party. Under the previous rules, the cost base of the sold shares did not account for the deemed dividend from the share buyback, meaning the capital gain (and subsequent tax liability) were smaller than they should have been. Recent amendments ensure that a deemed dividend calculated as a result of the share buyback will reduce the cost base of the remaining shares sold in a subsequent sale. This has the effect of increasing the taxable capital gain of the sale to account for the tax-exempt deemed dividend the shareholder received in the share buyback (accounting for any return of capital).

CHAPTER 3

Proposal to tax a deemed dividend portion of proceeds from selling shares

Summary

When a shareholder makes a gain on a sale of shares, it is in the form of a capital gain, which under current settings is usually not taxed. However, there are some cases where the sale also results in undistributed earnings of the company being realised by the shareholder in the form of part of the capital receipt. Some cases where this happens are referred to as “dividend stripping” and are potentially subject to recharacterisation as a dividend under section BG 1 or GB 1.

As discussed in the previous chapter, the anti-avoidance approach to identifying and counteracting dividend strips results in uncertainty for taxpayers as to the tax consequences of some sales of closely-held companies. For the Government, the current approach does not capture the full range of transactions where the amount received from selling shares includes a component of compensation for undistributed earnings. For instance, a sale of an active company to a third party is the least likely to be a dividend stripping transaction, regardless of the level of undistributed earnings in the company at the time of sale. This means that the tax rate imposed when those earnings are eventually distributed is not the tax rate of the seller, who owned the company when that income was earned, but the tax rate of the purchaser. It also allows a further deferral of taxing company earnings at the shareholder’s marginal tax rate. In addition, if all the company’s shares are bought by a company, the undistributed earnings may never be taxed even after being distributed to the ultimate individual shareholder.

This chapter proposes an objective approach which can provide more certainty to taxpayers and Inland Revenue.

General scope of a rule

- 3.1 The objective approach proposed in this chapter involves recharacterising share sales as dividends in the hands of the selling shareholder. A fundamental question is which transactions should be subject to the proposed recharacterisation rule.

A. Shareholder sells shares of a controlled company but retains economic ownership of the company

- 3.2 The clearest case of dividend stripping arises when a shareholder sells shares in a company it controls or owns for cash (or cash equivalent) but retains control or ownership. This is because, like a straightforward dividend, the shareholder has realised cash from selling the company but still owns or controls the company, as is illustrated in Example 1.

Example 1: Shares sold to company controlled by the shareholder

A shareholder on the 39% marginal rate of personal income tax forms a company (Bullseye) by contributing \$100 of capital.

Bullseye earns \$100 on which it pays \$28 tax. It does not distribute the earnings. Bullseye is now worth \$172 plus any value attributable to its imputation credits.

The shareholder forms a new company (Purchaser) to hold the shares of Bullseye. The shareholder transfers the shares in Bullseye to Purchaser in exchange for a promise from Purchaser to pay \$172 to the shareholder.

Bullseye pays a \$72 dividend to Purchaser. This is untaxed due to the inter-corporate dividend exemption. It could also be fully imputed.

Purchaser pays \$72 to the shareholder as partial repayment of the loan.

The shareholder receives \$72 cash from this transaction, paid out of the earnings of Bullseye, without paying any dividend top-up tax. While the shareholder also has the ability to receive an additional \$100 from Purchaser Co without paying any tax, this is merely equivalent to what it could have received as ASC from Bullseye in a share repurchase or liquidation of Bullseye. In addition, the \$28 in imputation credits are still available to Bullseye and Purchaser.

- 3.3 The type of transaction illustrated in Example 1 is the clearest case of converting a dividend into a capital receipt, as the shareholder has both received cash and retained the company, as it would have if Bullseye had paid a dividend. However, the shareholder is better off because it did not have to pay the "top-up" tax or use the imputation credits. In this case, current law will already treat the transaction as a dividend stripping transaction, and \$72 of the sale proceeds should be taxable as a dividend. However, such transactions may not always be self-assessed and may also not be known or pursued by Inland Revenue.

B. Shareholder sells shares of a controlled company to an unrelated company

- 3.4 Another dividend stripping scenario, Scenario B, is the essentially the same as Scenario A except:
- An unrelated person seeks to acquire all the shares in the target company.
 - The unrelated person forms a new company to acquire all the shares in the target company.
 - The unrelated person contributes an amount of capital to the purchaser company that equals the amount the purchaser company will pay the shareholder of the target company to acquire all the shares in the target company.

Example 2: Shares sold to unrelated company

A shareholder on the 39% tax rate forms a company (Bullseye) by contributing \$100 of capital.

Bullseye earns \$100 on which it pays \$28 tax. It does not distribute the earnings. Bullseye is now worth \$172 plus any value attributable to its imputation credits.

A person unrelated to the shareholder and to Bullseye seeks to acquire all the shares in Bullseye. The unrelated person forms a new company (Purchaser) for this purpose. They contribute \$172 of capital to Purchaser. Purchaser pays the shareholder of Bullseye \$172 to acquire 100 percent of the shares in Bullseye.

The shareholder of Bullseye has received \$172 cash. The shareholder's capital gain on the share sale of \$72 (\$172 less the original \$100 cost base) is a non-taxable capital gain. However, the \$72 gain represents undistributed retained earnings of Bullseye. The shareholder of Bullseye has not had to pay any top-up tax as it would have if \$72 were distributed as a dividend.

The consequences for Purchaser and its shareholder are:

- Purchaser has paid \$172 (market value) for Bullseye. \$72 of this represents undistributed retained earnings of Bullseye.
- \$28 of Bullseye's imputation credits are cancelled on the share sale.
- Bullseye has the potential to distribute the \$72 of retained earnings to Purchaser without any tax liability in the future due to the intercorporate dividend exemption.
- In addition, Purchaser has the potential to distribute the \$72 of retained earnings of Bullseye, as well as the additional \$100 paid to acquire Bullseye, to its shareholder without any tax consequences on a share repurchase or on liquidation as a return of ASC.

- 3.5 The overall result obtained in Example 2 is that the shareholder of Bullseye has received the \$72 value of Bullseye's retained earnings as a capital receipt and has not paid the top-up tax on it. In addition, even though Bullseye's imputation credits have been eliminated, it can distribute its \$72 of retained earnings to Purchaser and eventually to Purchaser's shareholder (via a share repurchase or a liquidation) without any additional tax being paid.

C. Shareholder sells shares of a controlled company to an unrelated individual

- 3.6 This scenario is the same as Scenario B, except the shares of the target company are purchased by an unrelated individual instead of a company.

Example 3: Shares sold to unrelated individual

A shareholder on the 39% tax rate forms a company (Bullseye) by contributing \$100 of capital.

Bullseye earns \$100 on which it pays \$28 tax. It does not distribute the earnings. Bullseye is now worth \$172 plus any value attributable to its imputation credits.

An individual pays the exiting shareholder \$172 for all the shares in Bullseye. The results of this are:

- The exiting shareholder has received \$172, of which \$72 is a non-taxable capital gain.
- That same \$72 of the purchase price represents the retained earnings of Bullseye.
- The exiting shareholder has not paid any top-up tax on the earnings of Bullseye that have been received in the form of a non-taxable capital receipt.

3.7 Scenario C is not as favourable to the new shareholder as Scenario B. In Example 3, the new shareholder has paid \$172 for Bullseye, but the ASC of Bullseye is still \$100. In addition, Bullseye has lost its \$28 of imputation credits. If the \$72 of retained earnings of Bullseye are distributed, they would be taxed as an unimputed dividend. This would also apply if Bullseye were liquidated.

3.8 In practice, the sale is more likely to be carried out as described in Example 2 (Scenario B), in order to realise the tax benefit of that approach. On the other hand, if Purchaser acquired less than 100 percent of the shares in Bullseye, carrying out the transaction in the manner described in Example 2 would not protect Purchaser from tax on a distribution from Bullseye since the inter-corporate dividend exemption would not apply.

3.9 Alternatively, to avoid an outcome which benefits the seller but hurts the purchaser, the parties to a sale could agree, for example, that the target company would distribute a dividend before the sale (the shareholder of the target company would pay the 11% top up tax), and the purchaser would pay less for the company to reflect the fact that its earnings had been distributed. A second option is for a dividend to be declared and reinvested in the company – this means that the retained earnings are converted into additional ASC, an amount distributable to the purchaser tax free on a share repurchase or on liquidation. Another option would be to negotiate a purchase price that reflects that the exiting shareholder of the target company gets a benefit in not having to pay the top-up tax on a dividend, and the purchaser will have to pay a penalty in the future for the possibility of deriving an unimputed dividend. If the purchaser thinks this possibility is far enough in the future they may be able to agree on a price that makes them both better off.

To which scenarios should a generic recharacterisation rule apply?

3.10 Of the possible scenarios for a rule to recharacterise a portion of the receipts from selling shares as a dividend, A is the narrowest in scope and C is the broadest in scope.

3.11 Scenario A is the one that most clearly looks like a transaction that results in the same outcome as if a dividend was paid. The shareholder receives value for

the retained earnings in the company in the form of cash or debt or some other consideration, and the shareholder retains economic ownership of the company (although the legal structure of the ownership changes). There are also significant tax advantages to this as not only are the earnings made available to the shareholder without any top-up tax being paid, the full imputation credits remain in the company and are available to be used later.

- 3.12 This sort of related party transaction is one where Inland Revenue often uses section BG 1 or GB 1 to treat the sale as a dividend stripping arrangement. This is also similar to a United States rule that treats part of the consideration for a controlled company's shares as potentially a dividend from both companies if the shares are sold to another company that is also controlled by the selling shareholder.¹⁴
- 3.13 Scenario B is also a way the selling shareholder can receive the value of the target company's retained earnings in the form of a non-taxable capital receipt. The buyer obtains no great advantage but is also not disadvantaged, except to the extent it loses imputation credits so that it cannot distribute pre-acquisition earnings without the distribution being taxed as a dividend unless it is done as a share cancellation or liquidation (although it can pay dividends out of post-acquisition earnings which generate imputation credits). Applying the recharacterisation rule to this type of sale would expand the concept of recharacterisation beyond what is now thought of as "dividend stripping" subject to section GB 1.
- 3.14 Scenario C has the broadest application. While it provides the selling shareholder the same benefit as Scenarios A and B, it appears to disadvantage the purchaser so it is more likely the purchaser would use a structure, such as in Scenario B. However, the tax advantages in Scenario B are only available if all the shares in the company are being sold. In Scenario C, the purchaser may also seek to have the seller pay itself a dividend before the sale, with the sale price being adjusted for that. If this were to happen the dividend would be taxed, so there would be no dividend recharacterisation required. However, it is also possible the parties could try to negotiate a purchase price which would give them both an advantage resulting from the seller not realising a taxable dividend.
- 3.15 It is proposed that a dividend recharacterisation rule may be applied to Scenarios A, B and C. All scenarios have the same consequence for the seller, although they have different consequences for the buyer. It seems appropriate that the shareholder who owned shares in a company when the company earned income would be taxed on the income when shares are sold for a price that includes the value of the company's retained earnings. Failure to tax the retained earnings component of the sale price would also allow deferral of the top-up tax to be extended for a potentially lengthy period.
- 3.16 Such a recharacterisation rule could encourage the parties to the sale to agree to terms such as the company paying a dividend to the selling shareholder before the sale, in exchange for the buyer paying a lower price for the shares. However, such a practice would produce an appropriate result from a tax perspective.
- 3.17 The remainder of this chapter will discuss how a recharacterisation rule could be designed, keeping in mind that it should apply to all three scenarios.

¹⁴ United States Internal Revenue Code section 304.

Details of a rule

3.18 The following criteria should all be considered in establishing a deemed dividend on share sale rule.

- To what sales of shares should the rule apply?
- How is the deemed dividend amount determined?
- What other consequential implications flow from the rule?

What share sales should the rule apply to?

Type of shareholder

3.19 The proposal will only apply to shareholders who are New Zealand resident natural persons (including natural persons who recognise the income as beneficiary income), trustees, and companies. The proposal will not apply to sales by shareholders, other than companies, that are taxed at 28%, such as PIEs, superannuation schemes and group investment funds. The reason for applying this rule to shareholders that are companies is discussed under other issues.

3.20 If the shareholder is a partnership, including a limited partnership, this rule will apply as if the partners directly owned and sold the shares in the company.

Type of company

3.21 Because the rule will require reference to the imputation credit account (ICA) balance to determine the deemed dividend amount, the Government proposes that this rule would apply only to sales of shares in companies that maintain an ICA. This would be New Zealand resident companies, and Australian resident companies that elect to maintain an ICA.

Shareholding size and control criteria

3.22 The proposed recharacterisation rule would only apply when shares in a company are sold by the controlling shareholder. An important point to bear in mind is that a shareholder who owns more than 50 percent of the voting interests in a company controls that company. The Government does not propose that a recharacterisation rule should apply to sales of shares in listed companies and sales by portfolio shareholders. This is because the shareholder may not have sufficient information about the tax attributes of the company in order to determine how much of the sale price should be recharacterised as a dividend (these will be discussed later in this chapter). Also, listed companies tend to have a high dividend payout rate anyway. Companies with low dividend payout rates tend to be closely-held companies.

3.23 The proceeds from a share sale would be recharacterised as a dividend if the shareholder (together with associates and other shareholders acting together) controls the company immediately before the sale. It should not matter how large the block of shares sold is, as long as the control criterion is met. This is so there is no ability to avoid recharacterisation by selling shares in small "drip feed" parcels.

Look back rule

3.24 A specific anti-avoidance rule is also proposed, which is intended to capture someone selling first a controlling interest in a company (which would be subject to this rule), followed by selling more shares to the same person (or an

associate) after they have divested control. To cover this, it is proposed that the rule would also cover share sales when all the following apply:

- The seller (together with associates) did not control the company immediately before the sale.
- The sale is made within two years of a previous sale of the company's shares by the seller, or an associate of the seller, to the same buyer (or an associate of that buyer).
- The control criterion applied at that time to the earlier sale of shares (that is, the company was controlled by the seller, together with associates, immediately before the earlier sale).

How much of the sale price should be taxable?

- 3.25 When shares of a company are sold, a number of different factors affect the value of the shares. These include the value of the underlying assets, including goodwill or capitalised expected future earnings. The value of shares in an operating company may be the higher of capitalised future earnings or the value of the company's net assets (liquidation value). Assets of a company can be funded from a number of financing sources including paid-in capital, company debt, and retained earnings. Retained earnings may include taxable income, capital gains, and other forms of income that are not included in taxable income.
- 3.26 The tax treatment that applies on the liquidation of a company is instructive for determining how much of a share sale receipt should be treated as a dividend. When a company is liquidated, the shareholders dispose of their shares for the assets of the company (which could be cash if the company has already sold its assets). When a shareholder sells shares to another person, the shareholder disposes of their shares for, usually, a combination of cash and debt.
- 3.27 In a liquidation, the amount that is a dividend is determined as a residual amount, meaning that all amounts that are not a dividend are determined first and the rest is treated as a dividend. The following are subtracted from the value of the company's property that was distributed in liquidation.
- Available subscribed capital (ASC).
 - The portion of retained earnings that are from realised capital gains.
 - The value of property that represents unrealised capital gains.
 - The difference between the (accounting) retained earnings derived from foreign portfolio shares subject to the fair dividend rate (FDR) regime and historic undistributed FDR income.
- 3.28 What remains is deemed to be a dividend. Imputation credits may be available to use against tax on this income.
- 3.29 Putting it another way, the dividend amount is taxable income plus income (other than capital gains and the FDR adjustment) that is not included in taxable income. In other words, it includes a clawback of preferences (other than capital gains) as does an operating dividend. The clawback of preferences is usually the amount of the dividend that is not fully imputed. With capital gains and an FDR adjustment specifically excluded from this amount in a liquidation, the potential clawback of preferences may not be significant. It may include things such as dividends from non-portfolio shares in a foreign company.
- 3.30 The Government does not propose duplicating the liquidation calculation for determining the dividend amount from the sale of shares. This is too complex

and uncertain. Determining the unrealised capital gain component if shares of an operating business are sold would be especially difficult, as there would likely be a significant goodwill component which could have increased in value over time.

- 3.31 Using an accounting concept of retained earnings is possible. This could be adjusted to remove capital gains. Accounting earnings could potentially also capture more earnings than taxable income and so pick up a clawback of preferences amount. However, a disadvantage is accounting standards are more flexible than tax rules, so the standards could vary by taxpayer. However, the degree of variability is still limited by the application of accounting standards, such as International Financial Reporting Standards (IFRS).
- 3.32 Another option is to refer to the company's ICA balance at the time of the sale in order to calculate the amount of undistributed taxable income that it represents. For example, a \$28 ICA balance could be deemed to represent a \$72 net dividend or a \$100 gross dividend implicit in the price paid for the shares.
- 3.33 We recognise that this is not a perfect measure. The ICA balance is broadly tax paid less tax refunds and imputation credits distributed. Typically, imputation credits are generated when provisional tax payments are made, and these could be a little higher than the actual tax liability if the uplift method is used to ensure the taxpayer is not charged use of money interest before the final instalment. On the other hand, the payments could be lower than the actual liability. Also, some adjustments, such as the shareholding change debit, could cause the grossed-up ICA to be unrepresentative of undistributed taxable income more significantly.
- 3.34 Both the accounting retained earnings and grossed-up ICA approaches have strengths and weaknesses. The Government therefore proposes to make the undistributed earnings portion of the grossed-up deemed dividend amount the higher of the grossed-up accounting retained earnings (less non-taxable capital gains) or the grossed-up ICA at the time of sale.

Consequences to seller

- 3.35 When a shareholder that (together with associates) controls a company sells shares in the company, a portion of the sale proceeds would be treated as a dividend. That portion is:
- the grossed-up undistributed earnings of the company at the time. This is the higher of:
 - the accounting retained earnings (less non-taxable capital gains) grossed-up to a pre-tax amount (by adding the ICA balance), or
 - the ICA balance divided by the company tax rate
 - pro-rated to the proportion of shares sold (the income interest of the shares sold as a percentage).
- 3.36 This is the amount of gross dividend income included as part of the sale price. If the sale price is less than the corresponding net dividend amount, then the sale price is the net dividend, and that must be grossed up by the amount of imputation credits that are or could be attached to determine the gross dividend.
- 3.37 The allocated ICA amount is then available to the shareholder to use as a credit. This is illustrated by way of examples later in this chapter. The effect is the

shareholder must pay the top up tax if its personal tax rate is higher than the company tax rate.

Consequences to the company

- 3.38 Since the retained earnings out of which the dividend is deemed to be paid remain in the company, the seller is treated as if it received the net dividend and immediately returned it to the company as additional capital. To reflect this, the ASC of the company is increased by the deemed net dividend.
- 3.39 If the ICA balance is not forfeited on sale (which would be the case if the shareholder sells the company to another company that it controls or the sale does not result in a 34 percent change in ownership since the credits arose), then the ICA balance is reduced by the amount of imputation credits used by the seller to reduce its tax on the deemed dividend.

Consequences to the buyer

- 3.40 There are no special consequences for the buyer. The buyer is treated as buying the shares for the price it paid for them, but it does get the benefit of additional ASC in the company generated by the deemed dividend.

Example 4: Calculation of deemed dividend and change in ASC

Shareholder S (an individual on the 39% marginal tax rate) forms company T by contributing \$1,000 to a newly incorporated company. T earns \$100 over the year. It pays \$28 in provisional tax. It does not pay a dividend. It has retained earnings of \$72 and an ICA balance of \$28.

S sells all the shares in T to P for \$1,072. The grossed-up deemed dividend is the ICA balance at the time divided by the company tax rate.

$$\$28 \div .28 = \$100.$$

The grossed-up retained earnings are also \$100.

$$\$72 + 28 = \$100$$

S is deemed to derive a grossed-up dividend of \$100. This is the same amount of income S would have received if S had been paid a fully imputed cash dividend of \$72. Tax on this is \$39. The \$28 imputation credit reduces the net tax to \$11.

Company T must eliminate its ICA balance due to breaching the shareholder continuity requirement for carrying forward imputation credits. Even if that rule didn't apply, Company T would decrease its ICA by the amount of imputation credits attached to the deemed dividend. In this case, the ICA balance is reduced from \$28 to nil.

The ASC of company T is increased by the amount of the deemed net dividend. The deemed net dividend is the deemed gross dividend reduced by the attached imputation credits.

$$\$100 - \$28 = \$72.$$

After the sale, the ASC of T is \$1,072.

Example 5: Calculation of deemed dividend and change in ASC

Pepperidge Profit Accumulating Biscuits Ltd. (PPAB) makes biscuits. It is owned by the Pepperidge family, Peter and Patty Pepperidge and their children Paul and Pam. Peter and Patty own 30 percent each and the children each own 20 percent.

PPAB was founded 15 years ago with a capital contribution of \$1 million. It has since made \$3 million from making and selling biscuits and has paid tax on that income. It has never paid a dividend. Some of its profits were reinvested in the business and some were used to invest in foreign shares. PPAB has earned \$300,000 from the investment in foreign shares, but the taxable income from the shares was \$250,000 under the FDR method. PPAB has paid company tax on the FDR income.

Paul has indicated he wants to sell out of the family business so he can start a new business making corn bread and grits. The family agreed the business was worth \$8 million and so he would sell his 20 percent interest to Pam for a payment of \$1.6 million. He acquired his shares as a gift from his parents and they have the original cost base of \$200,000.

Paul has a capital receipt of \$1.6 million. There is a \$1.4 million capital gain which is not taxable.

The retained earnings at the time of the sale are \$2,390,000 and Paul's 20 percent share of that is \$478,000. The ICA balance at the time of the sale is \$910,000 and Paul's 20 percent share of that is \$182,000.

Paul's gross deemed dividend is the higher of $\$182,000 \div .28 = \$650,000$, and $\$478,000 + 182,000 = \$660,000$. It has a deemed attached imputation credit of \$182,000. Paul's gross tax on the deemed dividend is $\$660,000 \times .39 = \$257,400$. After deducting the imputation credit of \$182,000 he must pay additional tax of \$75,400.

As the sale of shares was less than 34 percent, the ICA balance was not forfeited. However, as \$182,000 in imputation credits were attached to the deemed dividend, the company's ICA balance is reduced to \$728,000.

The net dividend is $\$660,000 - \$182,000 = \$478,000$. As the deemed net dividend amount was retained in the company, it is treated as if it were immediately contributed to capital. The ASC of the company is increased by \$478,000. This will prevent double taxation in the event of a liquidation since that amount has already been treated as a dividend.

Other issues

Should the amount of the deemed dividend be limited to the gain on the sale?

- 3.41 The Government does not propose to limit the deemed dividend to the gain on sale (rather, it should be limited to the total sale proceeds). This is because limiting it to the gain on sale would effectively allow a deduction for a capital loss.
- 3.42 If a company has accumulated \$100 over a year, you would expect it to appreciate in value by \$100 over the year. However, if the company only appreciates in value by \$50, it means some other asset or part of the business (such as goodwill or land) has depreciated by \$50 over the year. This means the deemed dividend amount should not be limited to the gain, as that would

implicitly allow the deemed dividend (which should be the entire \$100 of retained earnings) to be reduced by the capital loss.

Why apply the rule to sales by companies?

3.43 If the rule did not apply to sales by companies, it may be possible to prevent a deemed dividend from arising by using a holding company structure. Consider the following fact scenario:

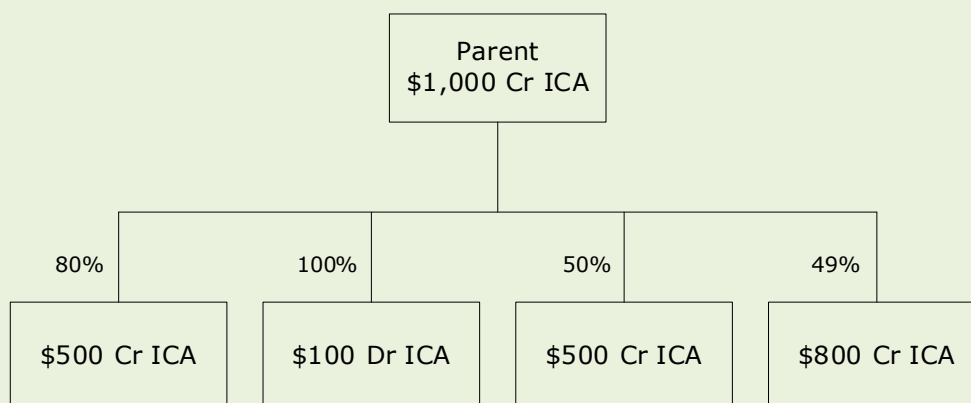
- A shareholder may own a holding company which owns an operating company.
- The operating company has retained earnings, but it never paid a dividend to the holding company.
- The holding company sells shares in the operating company, realising a capital gain (not taxed).
- The shareholder then sells the holding company (which holds the value of the company that was sold). The ICA balance of the holding company is nil, so this rule would not deem a dividend to arise to the shareholder from the second sale.

3.44 Applying the rule will address this issue because the first sale would result in a deemed dividend to the holding company, and this would transfer the ICA balance to the holding company. When the shareholder then sells the holding company, this rule would apply to deem a dividend arising to the shareholder.

Corporate groups

3.45 If a shareholder is selling shares in a parent company of a corporate group (a group being at least 50 percent common ownership), the ICA amount on which the deemed dividend is based should be the net of all ICA debits and credits of each company in the group, as well as the consolidated imputation group if there is one. For companies less than 100 percent owned, the individual ICA amounts should be pro-rated by the portion of ownership.

Example 6: Calculation of deemed dividend and change in ASC for group of companies



Parent, a company, has an ICA balance of \$1,000. It has subsidiaries with the following ICA balances:

- A company it owns 80 percent of with a \$500 balance.
- A company it owns 100 percent of with a \$100 debit balance.
- A company it owns 50 percent of with a \$500 balance.
- A company it owns 49 percent of with an \$800 balance.

If a shareholder sells its shares in Parent and this rule applies, the ICA balance used for determining the deemed dividend amount is calculated by summing the following amounts:

- \$1,000 (being Parent's ICA balance)
- \$400 ($\$500 \times 80\%$)
- $-\$100$
- \$250 ($\$500 \times 50\%$)
- Zero (the 49 percent-owned company is not taken into account).

The above calculation gives a total of \$1,550. If Parent has consolidated its accounting earnings with its subsidiaries, this amount should reflect the retained earnings of the group (so that would be the amount of retained earnings used without looking through to each underlying company).

ASC adjustments would apply for all companies that contributed to the calculation of the deemed dividend amount because they had retained earnings or a non-zero ICA balance. This would be the net dividend paid from their own retained earnings or grossed-up ICA, plus any amounts deemed on-paid by subsidiaries. The parent company would have an ASC adjustment of the entire net dividend amount deemed to have been derived by the shareholder.

Another approach may be to take the total deemed dividend amount, and pro-rate it among contributing companies in proportion to their respective ICA balances or retained earnings (with parents of subsidiaries also including their subsidiaries' amounts).

Sales of shares in a controlled company to another company controlled by the same shareholder

- 3.46 If shares in one controlled company are sold to another controlled company that also has retained earnings or an ICA balance, the amount received is potentially in substitution for dividends paid by both companies. Not only is the amount received by the shareholder potentially a payment for the retained earnings of the sold company, the purchasing company may pay for the shares out of its own retained earnings.
- 3.47 United States legislation provides that in this case, a dividend is deemed to be paid first by the purchasing company, and if that does not account for all that is paid for the shares, another dividend is deemed to be paid by the target company. This is because the cash or other consideration is being paid by the purchasing company to its shareholder, so it is the purchasing company's earnings that are being transferred to its shareholder. To the extent the purchase price exceeds this amount, it would be paid from the capital reserves of the purchasing company. However, as with the more general rule, if that amount is compensation for the retained earnings of the target company, that would be treated as a dividend from the target company.
- 3.48 In this case, it is proposed to follow the order used in the United States law (the amount received is first deemed to be paid out of the retained earnings of the purchasing company). This is calculated by grossing up the ICA balance or retained earnings of the purchasing company (or group) as described earlier in the context of determining the amount of a deemed dividend with respect to the sold company. As the purchasing company is paying cash or equivalent to the seller (consideration paid in the form of shares in the purchasing company is not taken into account in determining the amount of the deemed dividend), no amount is deemed to be recontributed to the purchasing company, and there is no adjustment to the ASC of the purchasing company for the deemed dividend amount.
- 3.49 However, the shareholder should still be entitled to the protection of the ASC of the target company in the case of a liquidation or share repurchase of the group, including the purchasing and target companies, as that ASC would have been available to reduce those amounts if the target company had continued to be owned directly by the shareholder. To reflect this, the ASC of the purchasing company should be increased by the lesser of the market value of the shares it acquired in the target company, and the ASC of the target company.
- 3.50 If the deemed dividend from the purchasing company does not account for the entire amount paid for the shares, then the amount of a deemed dividend from the target company is determined as described earlier, but this time it is limited to the amount paid after subtracting the deemed dividend from the purchasing company. The ASC of the target company is increased as described earlier. This increase in the ASC of the target company is deemed to happen immediately before the acquisition by the purchasing company, so the increase may also apply to the ASC of the purchaser (that is, an ASC increase of the lesser of the market value of the target company and the ASC of the target company).

Example 7: Sale of controlled company to another controlled company

A shareholder owns all the shares in two companies, Left Pocket Ltd (LPL) and Right Pocket Ltd (RPL).

LPL has ASC of \$3,000,000 and retained earnings of \$1,440,000. Its ICA balance is \$560,000.

RPL has ASC of \$1,000,000 and retained earnings of \$940,000. Its ICA balance is \$560,000. RPL had earned \$2,000,000 in taxable income but it has also had a \$500,000 capital loss.

The shareholder has decided that it prefers structure diagrams that look vertical instead of horizontal. It has decided that it will sell all the shares in RPL to LPL for its net asset value of \$1,940,000.

Consequences for LPL

In this situation, if there is a deemed dividend, it is deemed to arise first from the purchasing company.

The ICA of LPL is \$560,000. Dividing this amount by the company tax rate gives a potential gross deemed dividend of \$2,000,000 and a net dividend of \$1,440,000. As the net dividend amount is less than the amount paid for RPL, the entire \$2,000,000 is deemed to be a gross dividend the shareholder derived from LPL.

The shareholder's tax on the deemed dividend from LPL is $\$2,000,000 \times .39 = \$780,000$. After claiming the imputation credit of \$560,000, the shareholder must pay additional tax of \$220,000.

Since the entire ICA balance of \$560,000 was deemed to be attached to the dividend, LPL's ICA balance is reduced to nil. So that the shareholder is left in the same position from liquidating the parent company as if it liquidated the two companies separately (before reorganisation), the ASC of LPL is increased by the lesser of the value of the shares it received in RPL and RPL's ASC. This would increase the ASC of LPL by \$1,500,000 to \$4,500,000, taking into account the increase in the ASC of RPL discussed below.

Consequences for RPL

Since the amount paid for RPL was more than the net deemed dividend from LPL, it is necessary to see if there is also a deemed dividend from RPL.

The net deemed dividend from LPL was \$1,440,000. Since it paid \$1,940,000 for the shares in RPL, there is a remaining \$500,000 that could potentially be a net deemed dividend from RPL.

Dividing RPL's \$560,000 ICA balance by the company tax rate gives a maximum gross deemed dividend of \$2,000,000 and a maximum net dividend of \$1,440,000. Since the \$500,000 residual (from the amount paid by LPL for the shares in RPL) is less than the maximum net deemed dividend of RPL, the \$500,000 is deemed to be a net dividend derived by RPL's shareholder. A net dividend of \$500,000 is equivalent to a gross dividend of \$694,444.

The shareholder is deemed derive a gross dividend of \$694,444 from RPL. Tax at 39% is \$270,833. After taking into account the attached imputation credit of \$194,444, the shareholder has additional tax to pay of \$76,389 (in addition to the tax on the deemed dividend from LPL).

Since the ultimate shareholder of RPL has not changed as a result of the sale, RPL's ICA is not forfeited. However, it must debit its ICA account by the amount deemed attached to the dividend. This is \$194,444, so the ICA balance of RPL is reduced to \$365,556.

Questions for submitters

Submissions are sought on all aspects of this proposal, but in particular on the following questions:

- Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?
- Should the scope of the proposed recharacterisation rule cover all of scenarios A, B, or C, or only one or two of these scenarios?
- Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?
- Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?
- What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two), and which of these approaches do you prefer? Is there an alternative approach you would suggest?
- Do you agree with the proposed approach (outlined in Example 3) for calculating dividends and ASC adjustments for corporate groups?
- Is the approach outlined in Example 4 for a sale of one controlled company to another (existing) controlled company (potentially generating a deemed dividend from both companies) correct conceptually?

Part II: ASC and ACDA tracking accounts

CHAPTER 4

Current practice and issues

Summary

Distributions by a company are not taxable to the extent they are:

- a return of capital subscribed by shareholders (referred to as “available subscribed capital” (ASC)) on a liquidation or share cancellation, or
- a net capital gain of the company distributed in a liquidation.

When there is a share repurchase or liquidation, determining the dividend amount requires subtracting the ASC and the capital gain amount. Because a company may have been in existence for a long time before liquidation and these amounts may not be relevant before then, it is sometimes difficult for the company to determine them (going through historical records) and for Inland Revenue to verify them.

There are different ways to improve the reliability of this information. This chapter and the next consider two possible options:

- **Option one:** Require the amount of ASC and the capital gain amount to be determined annually and reported to Inland Revenue.
- **Option two:** Require taxpayers to record the information to evidence that they have calculated the dividend amount correctly (with Inland Revenue determining the amounts in the absence of reliable evidence), with no annual reporting requirement.

- 4.1 The determination of a company’s ASC and available capital distribution amount (ACDA) is provided for in sections CD 43 and CD 44 respectively.
- 4.2 The calculation of these amounts is not straightforward. The ASC definition has 40 subsections and comprises approximately 2,820 words. Although the core definition (amounts received for the issue of shares less amounts returned on the cancellation of shares) is simple enough, complexities arise by reason of the tax treatment of (among other things):
 - taxable bonus issues
 - share for share exchanges
 - shares issued as part of an employee share scheme, and
 - amalgamations.
- 4.3 In relation to ACDA, the calculation requires:
 - capital gains and losses to be calculated
 - an understanding of whether the transaction was with a related party or not, and
 - special calculations in relation to foreign investment fund (FIF) interests.
- 4.4 Not only are the rules complex, they change from time to time, meaning that the appropriate treatment of a transaction depends on the year in which it takes place.

- 4.5 An example of the kind of issue that can arise is where a company (the acquirer) issues its shares in exchange for 100 percent of the shares in another company (the target). From an accounting perspective, the acquirer will generally take the target into its books at the purchase price paid, and the increase in the acquirer's shareholders' equity will reflect the market value of the issued shares. However, for tax purposes, the ASC is limited to the historic amount paid to the target for the issue of its shares, whenever that occurred. Currently, there is no explicit requirement for any contemporaneous record of this discrepancy to be maintained.
- 4.6 In relation to both ASC and the ACDA, many years may pass between the occurrence of the transactions giving rise to positive or negative entries in the account, and the time when a distribution is made for which those entries are relevant. And in relation to ASC in particular, in many cases the figure will never be relevant. If the company is a wholly-owned subsidiary of another company at the time it is wound up, its ASC will be essentially unused. This may be the case for a company that is always part of a corporate group, or for a company initially owned by individuals or trusts and then sold to a corporate group.
- 4.7 In cases where a company does have to determine its ASC or ACDA, unless it has been very well run, the determination will often be extremely difficult, as it requires a careful record of both the law and transactions going back to the formation of the company.
- 4.8 There does not appear to be any explicit requirement for a company to keep records in relation to its ASC or ACDA. Section 22 of the Tax Administration Act 1994 (the TAA) does not apply, since these amounts are not required for the calculation of the company's own income or deductions (see section 22(2)(g) and (h) of the TAA). Nor are they otherwise specifically dealt with in that section.
- 4.9 Section 22AAB(2) of the TAA does require a person who is liable to pay RWT for resident passive income paid to another person to keep proper records relating to the income paid by them, sufficient to enable the Commissioner of Inland Revenue to ascertain the information set out in Schedule 3 table 2. Row 5 of table 2 refers to the amount of resident passive income. When a company makes a payment in consideration for the cancellation of shares, or makes a liquidating distribution, in order to ascertain the amount of a dividend (which could be zero) the Commissioner would require information about the company's ASC and ACDA. It is therefore arguable that section 22AAB(2) imposes a requirement to keep records. However, the section seems primarily directed to the ascertainment of information about who has received a dividend and when, rather than the ascertainment of whether a distribution to a shareholder is a dividend in the first place.
- 4.10 Despite the lack of any explicit requirement, a company that does not have records to substantiate its ASC and ACDA will effectively lose those amounts, as it will not be able to satisfy the burden of proof required to take a position that some or all of a distribution is not a dividend. This issue is considered in draft operational statement ED 0239, released in December 2021.

CHAPTER 5

Policy options

Summary

There is a strong case for amending the TAA to deal specifically with record keeping requirements in relation to ASC and ACDA, and maintaining tracking accounts for ASC and ACDA, similar to those that are maintained for imputation credits. Such accounts would prompt companies to keep contemporaneous records, and this would significantly improve the reliability of the figures. Contemporaneous accounts would also create an opportunity for the Commissioner to make a contemporaneous challenge to an ASC or ACDA increase, rather than having to wait until a distribution occurs to do so.

There is a question as to whether taxpayers should be required to submit these tracking accounts to Inland Revenue each year as part of the return filing process (similar to the IR4J process for imputation credit accounts), or if taxpayers should only be required to record the information and keep adequate supporting records to evidence that they have calculated the dividend amount correctly. In the event of an audit, Inland Revenue would determine the company's ASC and ACDA if the taxpayer cannot provide reliable evidence to support its calculations.

Record keeping

- 5.1 Dealing first with record keeping, the requirement would be for a company to keep sufficient records to enable the ready ascertainment by the Commissioner of the company's ASC and ACDA. These records would have to be maintained for the life of the company, rather than the usual seven-year period.
- 5.2 There is a question as to whether compliance with these requirements would be mandatory. Many companies have for their entire existence no more than nominal ASC. For companies which are wholly-owned subsidiaries, ASC is irrelevant (though ACDA is not). Accordingly, compliance with this record keeping requirement could be optional, with companies electing not to comply being entitled to no credit to their ASC or ACDA for the relevant years.

Memorandum accounts

- 5.3 Like an imputation credit account (ICA) the account would be a running total, with each year's closing balance forming the opening balance for the next. As noted above, there are two possible approaches in relation to tracking accounts for ASC and ACDA. The first is to require taxpayers to submit these accounts to Inland Revenue on an annual basis. If these accounts are not prepared for a year on a timely basis, the company would then have no ASC or ACDA for that year. The second is to require taxpayers to keep and maintain these accounts if they do not wish to have their ASC or ACDA be deemed to be zero, but without requiring taxpayers to submit these accounts to Inland Revenue. Under each option the company would still need to maintain sufficient records to evidence the amounts entered in the ASC and ACDA memorandum accounts. It would not be sufficient simply to maintain the memorandum account without retaining the records substantiating the account entries.

Option one: Accounts are reported to Inland Revenue annually

- 5.4 One benefit of requiring taxpayers to maintain tracking accounts and submit them to Inland Revenue annually is that this would serve as a prompt to taxpayers to maintain records. It would also provide Inland Revenue with information on a contemporaneous basis regarding movements in the account and allow it to investigate those movements.
- 5.5 Under this option, failure to submit a return of the tracking accounts by the due date would mean a taxpayer could not later increase the account balance by any amount for that period, except with the Commissioner's approval and if the required contemporaneous records were able to be provided. A hard time limit (for example, five years after the due date) might also be appropriate.
- 5.6 A further question is whether the return would be able to be re-opened by the Commissioner. The purpose of the return would be to assist taxpayer compliance. Its purpose would not be to place an onus on the Commissioner to audit the return. Accordingly, the Government does not propose placing a time limit on the Commissioner's ability to challenge a return in relation to the ACDA and ASC memorandum accounts. As a practical matter, the maintenance of contemporaneous records would make challenge at the time of a distribution relatively unlikely. Challenges would instead be made to entries in the accounts, within a relatively short time of those entries being made. The current time limit would continue to apply to assessments of shareholders in relation to distributions from the company, which would effectively mean the time bar applying from the point in time when the determination of a company's ASC or ACDA amounts became relevant for tax obligations.
- 5.7 As with the proposed record keeping requirement, compliance with a requirement to maintain tracking accounts could be optional, on the basis that companies that do not choose to maintain accounts would then have no ASC or ACDA.

Option two: Accounts required to be kept and maintained but not required to be reported to Inland Revenue annually

- 5.8 Under this option, rather than requiring tracking accounts for ASC and ACDA to be submitted to Inland Revenue annually, taxpayers would only be required to provide these accounts (along with supporting records) to Inland Revenue when this information is specifically requested, such as in the event of an audit. Similar to option one and the proposed record keeping requirement, maintenance of these tracking accounts could be optional (again, on the basis that companies that do not choose to maintain accounts would then have no ASC or ACDA).
- 5.9 The main benefit of not requiring tracking accounts to be submitted each year, but instead only requiring them to be kept by taxpayers would be lower compliance and administration costs in respect of amounts that do not affect taxable income for that particular year. The disadvantages of this from Inland Revenue's perspective would be reduced visibility of amounts being claimed by taxpayers as ASC and ACDA, and potentially reduced incentives for businesses to maintain accounts (although the potential loss of ASC and ACDA might provide sufficient incentive on its own).
- 5.10 Submissions are invited on whether tracking accounts should be required to be reported to Inland Revenue annually, or whether it would be sufficient to just require these accounts to be kept and maintained if a company does not want to have deemed ASC and ACDA of zero.

Transitional

- 5.11 The transitional issue here is considerable. Many, perhaps most, existing companies have not maintained contemporaneous ASC or ACDA, relying instead on calculating the figure on a retrospective basis if it ever becomes necessary to do so. Requiring all existing companies to undertake a retrospective calculation would be onerous, and in many cases ultimately pointless, as the company will be wound up when wholly owned by another company, or with no amount returned to the shareholders.
- 5.12 Accordingly, the Government proposes that any change to the rules would only take effect for transactions occurring after the law is enacted. To the extent a company's ASC and ACDA figures rely on transactions occurring before that date, the current law would continue to apply. A company will have the onus of proof in establishing the amount of ASC and ACDA (as is the usual case for tax matters), but this burden can be satisfied at the time the ASC and ACDA accounts become relevant (that is, when shares are repurchased or liquidating distributions are made to shareholders).
- 5.13 Over time a greater and greater percentage of the total amount of ASC and ACDA will be under the new rules. This will make the calculation of dividends on liquidation of a company, for instance, much easier to determine.
- 5.14 Thought will need to be given as to the order in which credits to the ASC account can be used. For example, suppose a company formed in 1990, which issues \$1 million of shares after the introduction of tracking accounts. The company then returns \$750,000 to its shareholders in a share repurchase transaction. Should this first be debited against ASC arising before the tracking account was set up, with any excess recognised in the new account, or should it first be debited against the amount in the account (which in this case would mean the historic ASC would remain untouched, but the ASC subject to the new rules would be only \$250,000)?
- 5.15 In favour of debiting the ASC tracking account is the fact that it will be well documented. On the other hand, debiting historic ASC would support the gradual elimination of such ASC.

Questions for submitters

Submissions are sought on all aspects of this proposal, but in particular on:

- Whether the proposed transitional rule is appropriate.
- Whether the Commissioner should be able to reopen a return and on what basis.
- Whether the proposal strikes an appropriate balance between compliance costs and tax integrity.
- Whether the ASC and ACDA memorandum accounts should be reported in annual returns.

Part III: Personal services income attribution

CHAPTER 6

Current law and problems

Summary

This chapter examines the current law concerning the attribution of personal services income. First, it looks at the personal services attribution rule, which applies in certain circumstances when income from “personal services” performed by an individual is earned through an entity, such as a company or a trust. It then examines the precedent set by the *Penny and Hooper* case and the challenges for Inland Revenue in applying this precedent to cases where a taxpayer uses an associated entity as a conduit for selling personal services.

Attribution rule for income from personal services

- 6.1 The Income Tax Act 2007 contains an attribution rule for income from personal services. The attribution rule, contained in sections GB 27 to GB 29, prevents an individual avoiding the top personal tax rate by diverting income to an associated entity. A typical scenario is where an individual incorporates a company to contract for services. The company contracts with the customer and pays the 28% corporate tax rate on its fee income. The company then employs or sub-contracts with the individual to provide the service, often at a below-market rate. The company can either retain its profit or pass the profit back to the taxpayer in a tax-advantaged manner (for example, through a trust).
- 6.2 The attribution rule for income from personal services applies when an individual (the working person), who performs personal services, is associated with an entity (the associated entity) that provides those personal services to a third person (the buyer). The rule only applies when various threshold tests are met, most notably:
- At least 80 percent of the associated entity’s income from personal services during the income year is derived from the supply of services to the buyer or an associate of the buyer (or some combination thereof). This is referred to throughout this chapter as the “80 percent one buyer” rule.
 - At least 80 percent of the associated entity’s income from personal services during the income year is derived from services that are performed by the working person or a relative of theirs (or some combination thereof). This is referred to as the “80 percent one natural person supplier” rule.
 - “Substantial business assets” are not a necessary part of the business structure that is used to derive the associated entity’s income from personal services.
- 6.3 The combination of these tests targets the rule at individuals who, using an interposed entity, sell their labour to a buyer in the specific situation where these individuals would likely have traditionally supplied their labour as employees, rather than as independent contractors.

Background and current law

Personal services attribution rule

- 6.4 The top personal tax rate was first increased to 39% in the year 2000. This provided an incentive for some employees and contractors to arrange their affairs so that they avoided paying the 39% rate. One of the responses was that simple avoidance schemes were targeted at people who would normally be regarded as employees. The policy response to this problem was to introduce the personal services attribution rule in 2000, shortly after the increase in the top personal rate took effect.
- 6.5 Under the personal services attribution rule, an amount of income of an associated entity is attributed to the working person, provided that:
- during the income year, the buyer acquires services from the associated entity
 - the services are personally performed by the working person
 - the working person is associated with the associated entity at the time the services are personally performed by the working person (using the general definition of "associated persons" in subpart YB of the Income Tax Act 2007)
 - the two 80 percent tests (referred to above) are both met
 - the working person's net income for the income year – assuming the personal services attribution rule applies to attribute the income of the associated entity to the working person – is more than \$70,000,¹⁵ and
 - as mentioned above, "substantial business assets" are not a necessary part of the business structure that is used to derive the associated entity's total income from personal services.¹⁶
- 6.6 In relation to the last of these conditions, "substantial business assets" means depreciable property that, at the end of the associated entity's corresponding income year, has a total cost of more than either \$75,000 or 25 percent of the associated entity's total income from services for the income year.¹⁷ In the case of depreciable property subject to a finance lease or hire purchase agreement, the cost of the property includes the consideration provided to the lessee, including expenditure or loss incurred by the lessee in installing the asset for use unless the lessee is allowed a deduction for the expenditure or loss.¹⁸
- 6.7 Section GB 27(3) provides a number of exemptions from the personal services attribution rule. Under the listed exemptions, the attribution of personal services income does not occur:
- if both the associated entity and working person are non-residents or, in some circumstances, if the associated entity is a controlled foreign company

¹⁵ Previously \$60,000, being the income threshold above which the former 39% marginal rate applied in 2000.

¹⁶ Section GB 27(1) and (2).

¹⁷ Section GB 28(6).

¹⁸ Section GB 28(7)(a).

- if the associated entity is a natural person and neither a partner of a partnership nor the trustee of a trust
- if the total amount of personal services income to be attributed to the working person is less than \$5,000, or
- to the extent to which the services personally performed by the working person are essential support for a product supplied by the associated entity.

Penny and Hooper v Commissioner of Inland Revenue

- 6.8 The top personal rate of 39% when viewed against the trustee and company tax rates (both of which remained at 33% in 2000 following the increase in the top personal rate) also provided an incentive for people who were not employees but who were instead operating small and medium businesses to arrange their affairs so that they avoided paying the 39% rate.
- 6.9 The most well-known of these cases, *Penny and Hooper v Commissioner of Inland Revenue*¹⁹ (referred to onwards as *Penny and Hooper*), concerned two orthopaedic surgeons who had both previously operated their surgery practices as sole traders – and who both (independently of one another) switched to operating their practices through a company they had incorporated before the increase in the top personal tax rate from 33% to 39%. Once the increase in the top personal tax rate took effect, each of the surgeons received a salary from his company that was well below the amount of income he had earned previously and was found to be well below market rates. The balance of the annual net income derived by each company from its surgery practice was distributed to the surgeon’s family trust and taxed at the trustee rate of 33%. The effect of this arrangement was to avoid paying the top-up tax of six cents in the dollar.
- 6.10 Having been introduced in 2000, the personal services attribution rule was in place during the income years that were at issue in *Penny and Hooper*. However, as the personal services attribution rule was introduced for a different purpose (being to address the specific issue with contractors who were similar to employees arranging their affairs to avoid the top personal tax rate), it did not apply to the facts of that specific case.
- 6.11 The case instead centred around whether the taxpayers’ use of corporate and family trust structures, combined with the “artificially low” salaries was tax avoidance for the purpose of the general anti-avoidance rule in section BG 1. In its ruling, the Supreme Court recognised there may be legitimate reasons for taxpayers to structure their business affairs using entities such as companies and trusts, but as the salaries were considered “contrived and artificial”, the Court upheld the earlier decision of the Court of Appeal that the arrangements in question were tax avoidance arrangements.

Issue

- 6.12 Now that a new top personal rate has been introduced at 39%, the Government is considering whether the current settings of the personal services attribution rule are still appropriate or if they might need to be updated.
- 6.13 As part of this, consideration is being given to whether the fundamental rationale and design of the personal services attribution rule should be shifted

¹⁹ *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95

from its original purpose of capturing employment like situations to instead apply more broadly to help to support the integrity of the 39% personal tax rate. This is because there is some concern that the rule in its current form may apply too narrowly, and therefore may not be effectively supporting the 39% personal tax rate as it is too easy for taxpayers to work around the rule.

- 6.14 There is a risk that taxpayers on the top personal tax rate of 39% will use trusts and companies to obtain a lower tax rate on what is in fact personal services income. This is an issue both for taxpayers providing personal services to a single customer (in which case the personal services attribution rule may apply) and taxpayers providing personal services to multiple customers (in which case the personal services attribution rule will not apply). In both cases, the economic reality is that the taxpayer is performing work and being paid for it – the entity is effectively just a conduit for the taxpayer’s income-earning activity. Consequently, the taxpayer should be taxed on their fee income at the applicable marginal rate. However, the legal structure used allows tax to be paid at the lower corporate rate. As such, there may be grounds in some instances for attributing the personal services income to the individual taxpayer and taxing it at their marginal rate.
- 6.15 The precedent set by the Supreme Court’s decision in *Penny and Hooper* covers similar ground to the personal services attribution rule. In some respects, the potential application of the *Penny and Hooper* precedent is broader than that of the personal services attribution rule, as the former is not constrained by the various threshold tests that limit the scope of the latter.
- 6.16 At the same time, reliance on the *Penny and Hooper* precedent has significant limitations from Inland Revenue’s perspective, owing to the fact that it is premised on the application of the general anti-avoidance rule in section BG 1. In particular the *Penny and Hooper* precedent will only apply to arrangements where there is an evident purpose of tax avoidance. It is not always obvious whether arrangements have such a purpose, and it can be time consuming and resource intensive to prove that there is one. The general experience has been that, when there is a specific and identifiable situation where avoidance is a concern, it is usually better to have a specific rule that addresses that concern than it is to rely on the general anti-avoidance rule. Further, the policy concern about the derivation of personal services income through companies is not restricted to arrangements with a purpose of tax avoidance. Therefore, it is preferable to have a specific “black letter” rule dealing with personal services rather than relying on section BG 1.

CHAPTER 7

Proposal

Summary

This chapter suggests a number of options for broadening the scope of the personal services attribution rule. If implemented, the changes suggested in this chapter would represent a shift in the focus of the rule from narrowly targeting taxpayers who are similar to employees, towards capturing a wider array of scenarios where an individual may use an associated entity as a conduit for selling their personal services to one or more customers.

“80 percent one buyer” rule

- 7.1 The “80 percent one buyer” rule described in the previous chapter narrowly targets the personal services attribution rule at taxpayers that are dependent on a single customer (and so are closer to employees). However, as also mentioned in that chapter, the problem is not limited to just those taxpayers that are dependent on a single customer. Example 8 illustrates how there might also be an issue when a taxpayer that performs personal services has multiple customers.

Example 8: Personal services business with multiple customers

Bill is an accountant who is the sole employee and shareholder of his company, A Plus Accounting Ltd. The company pays the 28% corporate tax rate on the income from accounting services provided to clients and pays a salary to Bill of \$70,000. Any residual profits are either retained in the company or are made available to Bill as loans.

Suggested solution

- 7.2 In light of this issue, the Government is proposing that the 80 percent one buyer rule be removed altogether. Submissions are invited on this proposal and whether there would be any issues if it proceeds into legislation.

Example 9: Effect of removing 80 percent one buyer rule

Consider Bill in Example 8. Assuming the 80 percent one buyer rule is removed, the personal services attribution rule would apply so that the income of A Plus Accounting Ltd (the associated entity) is attributed to Bill (the working person). This is because:

- During the income year, the buyers (clients) acquire services from the associated entity (A Plus Accounting Ltd).
- The services are personally performed by the working person (Bill).
- Bill is associated with A Plus Accounting Ltd at the time the services are personally performed by Bill.
- More than 80 percent of A Plus Accounting Ltd's income from personal services during the income year is derived from services that are performed by Bill.
- Bill's net income for the income year – assuming the personal services attribution rule applies to attribute the income of A Plus Accounting Ltd to Bill – is more than \$70,000.
- Substantial business assets are not a necessary part of the business structure that is used to derive A Plus Accounting Ltd's total income from personal services (the only business assets of A Plus Accounting Ltd are basic office furniture and equipment, which only cost \$20,000 in total, easily below 25 percent of the amount of income A Plus Accounting Ltd derives annually from personal services).

“80 percent one natural person supplier” rule

- 7.3 As described in the previous chapter, the “80 percent one natural person supplier” rule requires that at least 80 percent of the associated entity's income from personal services during the income year is derived from services that are performed by the working person or a relative of theirs, or some combination thereof.
- 7.4 In some circumstances, this rule might potentially be seen as too restrictive. Conceivably, there may be another individual (unrelated to the working person from whose efforts most of the associated entity's income from personal services is derived) whose labour contributes more than 20 percent of the associated entity's income from personal services. There is a question as to whether it is correct from a policy perspective that attribution does not apply even if the associated entity's income from personal services is *mostly* derived by the efforts of one person and/or a relative of theirs, simply because the entity's income from personal services is not almost entirely derived by the person's and/or a relative's efforts. This is essentially a question about where the threshold for attribution should be for the level of contribution of the working person, rather than a significant change in intended scope.

Suggested solution

- 7.5 One possible option the Government is considering is lowering the 80 percent threshold for the test to 50 percent. In other words, the personal services attribution rule would apply if the associated entity's income from personal services is *mostly* derived by the efforts of one person and/or a relative of

theirs, rather than almost all the entity's income from personal services being derived by the person's and/or a relative's efforts.

- 7.6 Submissions are invited on whether this suggestion is a sensible one, and whether there are any foreseeable problems with it.

Substantial business assets test

- 7.7 As outlined in the previous chapter, the threshold for the substantial business assets test is currently the lower of \$75,000 or 25 percent of the associated entity's income from personal services for the income year. This threshold has not changed since the introduction of the personal services attribution rule in 2000. There is a question as to whether the \$75,000 threshold in this test should be revised upward so that it is set at a level that more accurately reflects the cost of business assets today.

Suggested solution

- 7.8 The Government suggests two possible options for increasing the threshold:
- **Option one:** The lower of **\$200,000** or 25 percent of the associated entity's income from personal services for the income year, excluding the cost of passenger or luxury vehicles unless the entity's business is a transportation business.
 - **Option two:** The lower of **\$150,000** or 25 percent of the associated entity's income from personal services for the income year, excluding the cost of passenger or luxury vehicles unless the entity's business is a transportation business.
- 7.9 The suggested exclusion of passenger and luxury vehicles for the purposes of determining whether the cost of the associated entity's depreciable property exceeds the substantial business assets threshold is in recognition of a number of factors. Namely, vehicles are not always purely business assets; they can cost substantially more than is necessary for a business purpose; and they are often more incidental rather than integral to the work performed by the working person (in that they are how the person travels to the work in a lot of cases, rather than how they do the work).
- 7.10 Any increase in the threshold will not affect taxpayers whose business assets cost more than 25 percent of their income. The effective threshold will therefore only be greater than \$75,000 where the income from personal services for the income year is greater than \$300,000. Submissions are invited on whether the suggested thresholds are appropriate, and whether there is a better option for increasing the threshold for the substantial business assets test.

Net income of working person test

- 7.11 For the personal services attribution rule to apply, the working person's net income for the income year must be more than \$70,000. In determining whether the \$70,000 threshold is exceeded, it is first assumed that the personal services attribution rule applies to attribute the income of the associated entity to the working person.
- 7.12 Given the main purpose of a possible expansion of the personal services attribution rule is to ensure the integrity of the top personal tax rate of 39%, some parties may see a rationale for increasing the \$70,000 threshold. However, it is noted that a five percent differential still exists between the 33% personal tax rate (which applies to each dollar of income earned between

\$70,001 and \$180,000) and the company tax rate (currently 28%). As such, there may be a tax deferral benefit or incentive in relation to income earned between \$70,001 and \$180,000. Accordingly, the Government does not propose to increase the \$70,000 threshold. However, feedback on this point is welcome.

Questions for submitters

- Do you agree with the proposed removal of the “80 percent one buyer” test? Why/why not?
- Do you agree with the suggested decrease in the threshold for the “80 percent one natural person supplier” test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?
- Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?
- Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter?
- Do you consider the net income threshold should be increased from \$70,000 per year to \$180,000?