



POLICY AND REGULATORY STEWARDSHIP



Tax policy report: Integrity of the 39% top personal income tax rate

Date:	30 September 2021	Priority:	High
Security level:	Sensitive	Report number:	T2021/277 IR2021/063

Action sought

	Action sought	Deadline
Minister of Finance	Discuss this report with officials Agree to recommendations	s 9(2)(a)
Minister of Revenue	Discuss this report with officials Agree to recommendations	s 9(2)(a)

Contact for telephone discussion (if required)

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30 September 2021

Minister of Finance
Minister of Revenue

Integrity of the 39% top personal income tax rate

Executive summary

Purpose of report

1. You previously directed officials to report back to you¹ with advice on measures to mitigate integrity risks associated with companies, trusts and PIEs arising from the new top personal income tax rate [IR2020/454; T2020/3412 refers]. This report seeks your agreement to the possible integrity measures that will be worked on, and timeframes.
2. Different integrity measures complement each other to varying degrees. For example, some support integrity for investments made through controlled entities, some for portfolio investments, and some for earning personal services income through entities.
3. Coherence, integrity and fairness considerations would support progressing all the streams of work to reduce the distortions in the system; the streams of work are complex, have broader implications, and would require significant work. However, some streams of work are more important than others in relation to integrity, and some depend on policy decisions to be made in the future (such as whether the trustee rate should be raised).
4. This report, therefore, recommends that the streams of work be progressed in separate tranches. Officials recommend the first tranche comprise a package of primarily company integrity measures. This would include dividend integrity and income attribution measures. The other company and the trust integrity measures could then be delivered as a subsequent tranche once a decision is made on whether or not to raise the trustee tax rate to 39%. You could also consider whether to increase the portfolio investment entity (PIE) tax rate as a possible third tranche. The three proposed tranches are summarised below.

First tranche: Dividend integrity and income attribution measures

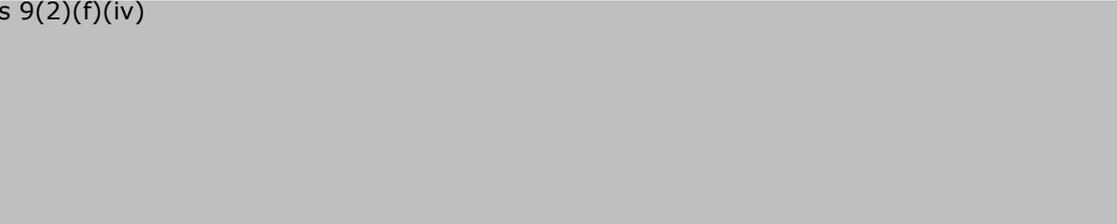
5. Officials recommend that the following package of measures be introduced first:
 - **Dividend integrity:** Officials have been working on a series of potential measures to counter some specific mechanisms that allow shareholders of closely-held companies to receive distributions from these companies without paying tax at their personal income tax rate. Some of these measures are currently on the published tax policy work programme. The proposed measures would:
 - deem a dividend to be paid to a shareholder when a company with undistributed income is sold;

¹ This report has been delayed due to the high priority given to housing issues in the last few months.

- improve the reliability of information used to determine whether a taxable dividend amount could arise from a share cancellation or liquidation in the future².
 - **Income attribution:** There is a risk that high rate taxpayers may use trusts and companies to obtain a lower tax rate on what is really personal services income. Officials recommend that the current personal income attribution rules be broadened to prevent this.
 - **Trust information gathering measures:** Officials recently reported to you on the trust information gathering measures. This information will be very useful in allowing us to determine whether trusts are being used to avoid the 39% rate. This information should start becoming available from July 2023. Officials will also continue to monitor whether trusts are being used to avoid the 39% rate.
6. Further, there are already some dividend integrity rules in the legislation. Inland Revenue is planning some operational work to improve compliance with these existing rules.
 7. These company tax integrity measures are unlikely to have major negative economic effects. By making the tax treatment of income earned in different ways more neutral, the measures are likely to be raising revenue at a relatively low economic cost per dollar raised.
 8. s 9(2)(f)
(iv) 
 9. Officials propose preparing a consultation document on these measures. Changes to the taxation of housing investments are now the priority for tax policy resources, but we should be able to complete this document in early 2022. This would allow for introduction of a bill later in 2022, with an application date of 1 April 2023.

Second tranche: Company and Trust integrity measures

Trust integrity measures

10. The integrity risk from trusts arises because income retained in a trust is taxed as trustee income at a 33% final tax. There is no additional tax when the income is subsequently distributed to a higher tax rate beneficiary. So high rate taxpayers who earn income through a trust will only pay tax at 33% under the current rules.
11. This is the most significant issue for ensuring the 39% personal income tax rate applies to high income individuals. For example, under the current settings any company integrity measures adopted would have limited effect if taxpayers own companies through trusts.
12. s 9(2)(f)(iv) 

² This would include information regarding available subscribed capital and net capital gains and net capital gains. Available subscribed capital is basically the amount of capital contributed to the company by shareholders less any untaxed returns of capital on a share repurchase or cancellation.

s 9(2)(f)(iv)

- 13. Officials note that Cabinet decided in December 2020 to defer the decision on whether to increase the trustee income tax rate to 39%, pending information on whether there has been a behavioural response by taxpayers to avoid paying the new personal income tax rate. A decision to raise the trustee rate would make the other measures unnecessary. Because of this, officials recommend that the decision on introducing alternative trust measures be deferred to when the decision on whether to increase the trustee income tax rate is made.
- 14. Finally, the Government has announced that it will introduce new information gathering powers to determine whether trusts are being used to avoid the 39% rate. This means that even if the decision is made to leave the trustee rate at 33%, waiting will allow us to use this information to improve the design of the alternative measures. Further, taxpayers might question why the alternative measures are being progressed before Inland Revenue had collected the information required to determine their necessity.

Further company integrity measures

- 15. Further integrity issues also arise in relation to companies. Shareholders can leave earnings in a company and pay the company income tax rate (currently 28%) on any returns from investments made by the company with those earnings. Even if those investment returns are later paid out as a dividend (and so taxed at the shareholder's marginal tax rate), shareholders get a deferral benefit as a result of the lower company rate. Officials could report to you on possible options to mitigate this issue. s 9(2)(f)(iv)

[Redacted]

- 16. s 9(2)(f)(iv)

- 17. s 9(2)(f)(iv)

- 18. A further issue concerns shareholder loans. In practice, shareholders can receive funds from a company without paying tax by receiving the funds as a loan. s 9(2)(f)(iv)

[Redacted]

Timing

19. Officials propose reporting back on whether trusts are being used to avoid the 39% tax rate in the second half of 2023. We will report to you on the second tranche at this time.

Third tranche: Possible future measures – PIE rates

20. There is an overlap between the 39% tax rate and how PIEs, including KiwiSaver, are taxed. PIEs are typically widely-held managed funds. This means a person cannot easily divert income they control through a PIE. Instead PIEs are an alternative way people can save. The issue with PIEs is whether it is appropriate for this form of saving to be taxed at a lower rate for high income earners than other forms of saving. Accordingly this is less of an integrity issue and more an issue about the coherence of our policy settings for taxing savings.
21. Whether the taxation of PIEs should be changed is partly dependent on whether a decision is made on taxing trusts at 39%. If trusts are not taxed at 39%, then there is a much weaker case to tax PIEs at 39%. You may also wish to treat KiwiSaver PIEs differently from other PIEs (to recognise the fact that KiwiSaver funds are generally "locked in" until retirement age). So the decision of whether to raise the top PIE tax rate is not straightforward.
22. For these reasons, officials recommend deferring any decisions on PIEs until after the first and second tranches have been agreed.
23. The table in the attached appendix sets out all the potential integrity measures in more detail.

Recommended action

24. We recommend that you:
- a. **Direct** officials to draft a consultation document (for release in early 2022) on the proposed first tranche of integrity measures to:
- a.1 in appropriate circumstances, treat as a dividend some amounts relating to the sale of shares in a company with undistributed income;
- a.2 improve the reliability of information used to determine whether a taxable dividend amount could arise from a share cancellation or liquidation in the future; and
- a.3 broaden the existing income attribution rules, to prevent the use of trusts and companies to obtain a lower tax rate on what is really personal services income.
- Agreed/Not Agreed Agreed/Not Agreed
- b. **Note** that Inland Revenue is planning to take operational measures to improve taxpayer compliance with existing dividend integrity rules.
- c. **Note** that officials will also continue to monitor whether trusts are being used to avoid the 39% rate.
- d. **Note** that officials will report to you in the second half of 2023 on:

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- d.1 whether trusts are being used to avoid the 39% tax rate, and if so, what measures should be taken to prevent this; and
 - d.2 a second tranche of company-focussed integrity measures.
- e. **Note** that officials could report to you on changing PIE tax rates once tranche one and tranche two have been agreed.

s 9(2)(a)



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Hon Grant Robertson
Minister of Finance
/ /2021

Hon David Parker
Minister of Revenue
/ /2021

Purpose of this report

25. The purpose of this report is to get your agreement on the schedule of work to address integrity issues arising from the introduction of the new top personal tax rate of 39%.

Background

26. The level of taxes paid on income from an investment or activity can vary depending on the entity structure used. This means taxpayers can arrange their affairs in ways that may compromise the Government's tax objectives. In particular, high income taxpayers can reduce the amount of their income that is subject to either the 33% tax rate or the new 39% tax rate. This possibility has been called the integrity issue.
27. This report:
- outlines the differences in taxation of income earned through different entities compared to income earned directly by individual taxpayers;
 - demonstrates how this can compromise integrity by reducing effective tax burdens on some types of income;
 - provides advice on measures to support the integrity of the 39% personal income tax rate; and
 - discusses possible next steps in this area.

Tax treatment varies for different entities

28. The tax treatment of income earned through different entities can vary significantly. The tax differences can be temporary or permanent. A temporary benefit allows a deferral of tax. Even if the cumulative tax burden is eventually the same, a deferral over an extended period can result in a significant difference in funds available at the end of the period.
29. The tax treatment of distributions from entities to individuals also varies by entity type. In some cases, there are permanent differences in taxes paid.
30. The following table summarises the tax treatment of different types of entity as income is earned, and as accumulated funds are distributed to individuals. The table assumes that the individual is subject to the top personal income tax rate.

Table 1: Tax treatment of different entity structures

Entity	Tax rate on income as it is earned	Tax treatment of distributions to high rate individuals
Individual	39%	n/a
Company	28%	Imputation tops up tax to 39%
Trust	33%	No top up on income if retained until the following year
Company owned by trust	28%	Top up to 33%, if income retained in trust until following year
Company with accumulated income realised by owner through a sale of its shares rather than a distribution	28%	No tax as dividend is avoided
Multi-rate PIE	Capped at 28%	No tax on distribution

31. The following table shows the effective tax burden paid on income earned in an entity and distributed to an individual with a 39% marginal rate.

Table 2: Effective tax burden on different entity structures

Entity	Year accumulated funds distributed		
	1	10	30
Individual	39%	39%	39%
Company	39%	38%	35%
Trust	33%	33%	33%
Company owned by trust	33%	32%	31%
Company with accumulated income realised by owner through a sale of its shares rather than a distribution	28%	28%	28%
Multi-rate PIE	28%	28%	28%

32. A number of observations can be made from this table.

- A company on its own gives rise only to a deferral of tax because of the imputation system. Quite long deferral periods are necessary to significantly lower the effective tax rate.
- Using a trust allows the new top tax rate to be avoided entirely, meaning 39% rate individuals pay only 33%.
- The combination of a company and a trust (the usual structure) can achieve an even greater reduction in the effective tax burden if profits are held in the company for a longer period of time to defer the application of trustee tax.
- When the taxation of dividends is avoided through a share sale, only the 28% company tax is paid.
- A 28% tax rate can also be obtained by investing in a PIE.

33. The biggest area of concern relates to closely-held companies and trusts that are used to earn income on behalf of high wealth individuals. Inland Revenue analysed 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. For 2018, individuals paid \$26 million in tax while companies and trusts paid \$639 million and \$102 million respectively, showing a significant amount of income earned through lower tax rate entities. The policy options considered in this report would not attribute all of this income to individuals and tax it at their individual personal tax rates, but would create the potential for a significant amount of income (that is derived by comparatively few individuals and families) to be recharacterised and taxed at the appropriate rate.
34. 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.
35. There are some integrity issues for taxpayers on a 33% tax rate however, the scale of the tax benefit for 33% rate taxpayers compared to taxpayers on 39% is significantly smaller in relation to companies (5% versus 11%) and it does not exist at all for trusts (which are taxed at 33%). Further, individuals on a 33% rate are likely to have less total income to divert through other entities than individuals on a 39% rate. Accordingly, the integrity issues are much greater for taxpayers on a 39% rate than for other taxpayers. For this reason, this report focuses on integrity measures to address potential avoidance by 39% rate taxpayers.

Integrity measures

36. During the 2020 election, the Labour Party announced an intention to establish a new personal income tax rate of 39% for income over \$180,000. Tax rates on other types of taxpayers, including companies and trusts, would remain unchanged at 28% and 33% respectively.
37. Officials understand the motivation for this reform is 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.
38. The current tax policy settings are a 39% top personal marginal tax rate with a 28% company income tax rate, a 33% trustee rate (pending a later review of the use of trusts to avoid the top personal rate) and no general capital gains tax. Any integrity measures should be consistent with these broader settings.
39. This means the integrity measures should focus on mechanisms that divert the income of a 39% rate taxpayer through channels that allow it to be taxed at a lower rate. The measures should not, for example, result in companies being taxed at 39%.
40. The income diverted can be either personal services income or income from investments. Officials consider that the integrity measures should apply to both types of income. Otherwise, one type of income will effectively receive a preferential tax treatment. This would reduce the effectiveness of the 39% tax rate and create horizontal inequity between taxpayers earning labour income and taxpayers earning investment income.
41. With this in mind, officials recommend that the integrity measures focus on limiting the ability of individuals to avoid the 39% rate by diverting their income through entities taxed at a lower rate. A combination of measures that could achieve this are:
 - Attributing personal services income earned through a company or trust (unless the trustee income tax rate is increased to 39%) by a controlling

shareholder or significant beneficiary to that individual and taxing it at their personal tax rate.

- Ensuring income is taxed at the recipient's personal income tax rate when distributed by a company or trust.

- s 9(2)(f)(iv)

42. s 9(2)(f)(iv)

43. s 9(2)(f)(iv)

However the trust related integrity measures and any changes to PIE taxation are dependent on the Government's decision on whether to increase the top trustee rate to 39%.

44. For these reasons, officials recommend progressing the combined integrity package in three tranches:

- **Tranche one**, comprising dividend integrity, information gathering, and income attribution measures.
- **Tranche two**, comprising trust integrity and income retention measures.
- A possible **tranche three**, comprising changes to PIE taxation.

45. Each tranche is discussed below.

First tranche – dividend integrity measures and income attribution measures

46. This tranche would include the following measures.

Amounts received when selling shares in a controlled company with undistributed earnings

47. When a shareholder sells shares in a company with undistributed earnings, some of the purchase price received is compensation for those retained earnings. The purchase price is typically treated as a capital receipt and is not subject to tax in the hands of the shareholder. If the earnings were instead distributed as a dividend, the dividend would have been taxed at the shareholder's personal income tax rate (and the buyer would have paid less for the shares). Officials' proposal is to treat the sale proceeds received by a controlling shareholder as a dividend to the extent of the undistributed earnings.

Improving the reliability of available subscribed capital and similar information

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

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

49. When there is a share repurchase or liquidation, determining the dividend amount requires subtracting the available subscribed capital amount and the capital gain amount (in the case of a liquidation). Because a company may be 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.

50. There are different ways to improve the reliability of this information. One possible option is to require that the amounts be determined annually and reported to Inland Revenue. Alternately, taxpayers could be required 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). The goal is to improve the accuracy of the dividend amount calculated in cases of share cancellations and liquidations (without imposing unnecessary compliance costs) and thus to prevent a possible source of revenue leakage.
51. There are advantages and disadvantages to the different options which officials would like to explore further through consultation on the discussion document for tranche one. We would report back to you on our recommended option following this consultation.

Income attribution

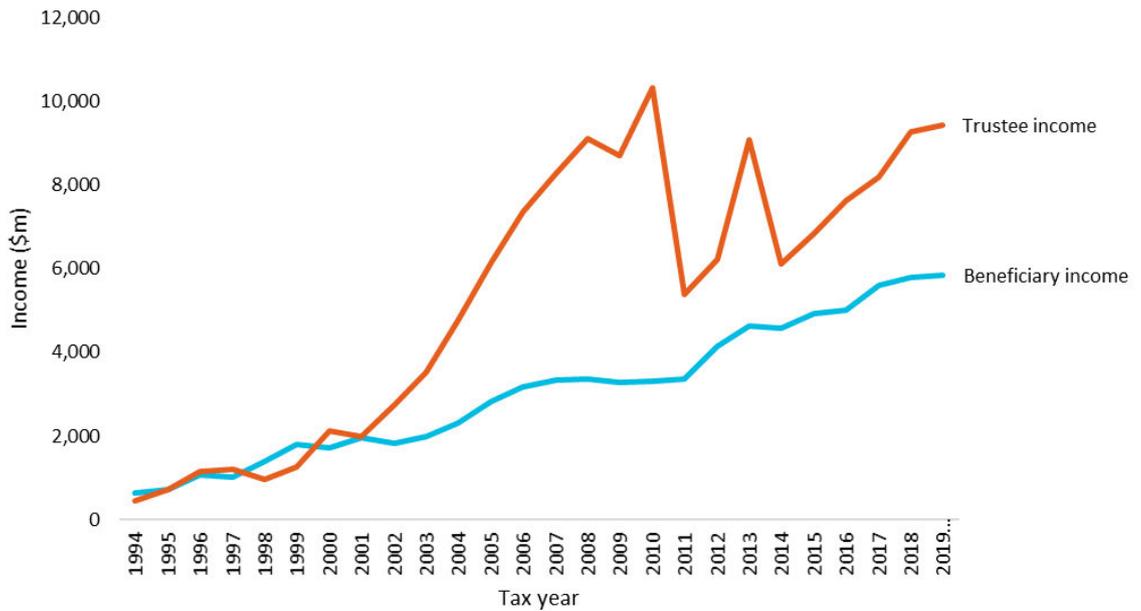
52. There is a risk that high rate taxpayers will use trusts and companies to obtain a lower tax rate on what is really personal services income. This is typically done by incorporating a company to contract for services. The company contracts with the client, and pays the 28% corporate tax rate on its fee income. The company then employs (or sub-contracts with) the taxpayer to provide the service (often at below market rates). The company can either retain its profit or pass the profit back to the taxpayer in a tax advantaged manner (for example, as a loan or through a trust). This is an issue both for taxpayers providing services to a single client, and for taxpayers that provide services to multiple clients.
53. In this case, the economic reality is that the taxpayer is providing services and being paid for them. Consequently the taxpayer should be taxed at its marginal rate on the fee income. However, the legal structure used allows tax to be paid at the lower corporate rate. Accordingly there are strong grounds for attributing the services income to the taxpayer and taxing it at the taxpayer's marginal rate.
54. The Income Tax Act 2007 currently includes some personal services attribution rules, but these are narrowly targeted at taxpayers that are dependent on a single client (and so are closer to employees). The proposal would expand these rules so they apply more broadly, including where the taxpayer has multiple clients. The intention is to attribute to a taxpayer income earned by an entity if that entity is effectively just a conduit for the taxpayer's activities. Accordingly, the proposal would apply to income earned through a company or trust that is under the control of the taxpayer and its associates (or possibly a small number of taxpayers).

Second tranche – Trust and income retention integrity measures

Trust integrity

55. The integrity risk from trusts arises because income retained in a trust is taxed as trustee income at 33% as a final tax. There is no additional tax when the income is subsequently distributed to a higher personal income tax rate beneficiary, so they do not need to pay the top personal income tax rate on the income.

Figure 1: Trustee and beneficiary income since 1994



Source: Inland Revenue

56. Figure 1 shows how significant amounts of income were diverted into trusts when the personal income tax rate was raised to 39% in 2000 while the trustee income tax rate remained at 33%.³ Many of the trust structures that were set up around that time are still being used and provide a structure that could be used now to reduce tax unless the trustee income tax rate is aligned with the highest personal income tax rate.

57. In addition to the above data, Inland Revenue will be receiving more specific information from trustees under provisions in the recently enacted new 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.

58. Addressing the integrity issue with the trustee income tax rate is probably the most significant issue to ensure the 39% personal income tax rate is imposed for high income individuals. Even if other integrity measures are adopted (for example, countering the use of company structures and dividend arrangements to reduce tax), these measures will be limited in their effect if taxpayers are taxed at only 33% on income earned through a trust.

59. s 9(2)(f)(iv)

60. s 9(2)(f)(iv)

³ The spike in 2013 was due to the expiration of an imputation credit transitional rule which allowed dividends to be imputed at a higher rate. The spike is from dividends of companies owned by the trust that were distributed to the trust.

s 9(2)(f)(iv)

Income retention integrity

- 61. As noted above, 39% rate taxpayers can get a deferral benefit from investing through a company or trust even if distributions are taxed at 39%. This deferral benefit can be significant if income is retained in the entity for a long time.
- 62. Officials could report to you on possible options to mitigate this issue. s 9(2)(f)(iv)

Shareholder loans

- 63. s 9(2)(f)(iv)
- 64. Officials could consider approaches to address this issue such as those that have been adopted in Canada and the UK. These countries deem a loan to a controlling shareholder that is outstanding at the end of the year to be a dividend in some circumstances. We could also consider improving the rules that treat the forgiveness of a loan owed by a shareholder to a company as a dividend (relevant in those cases where the loan has not already been treated as a dividend). In considering this issue, we need to be careful that any solution does not overreach and penalise valid commercial arrangements.

Possible third tranche – portfolio investment entities (PIEs)

- 65. Portfolio investment entities (PIEs) are vehicles that hold portfolio investments for investors. These include multi-rate PIEs (that is, managed funds including KiwiSaver funds) which pay tax on behalf of their investors using a progressive scale. The tax rates approximately follow the personal income tax scale except the top PIE tax rate is capped at 28%. There is no further tax on distribution to the investor. This means higher rate taxpayers can obtain the benefit of the capped rate by investing in a PIE.
- 66. While the difference between the top PIE rate and top personal income tax rate already existed prior to the introduction of the 39% top personal tax rate, moving from a five percentage point difference to an 11 percentage point difference could

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result in a greater diversion of investment into PIEs. This would result in reduced revenue collection and a small economic cost⁴ and mean that higher income taxpayers could circumvent the new 39% income tax rate on their investment income.

67. The taxation of PIEs is not an integrity issue per se. PIEs are widely-held investment funds, meaning an individual taxpayer cannot easily divert their income from a particular source through a PIE. Further, the taxpayer loses control of their funds if they invest in a PIE – their funds are combined with those of other members and invested at the direction of an independent fund manager. So the PIE cannot be regarded as simply a conduit for the taxpayer.
68. Consequently, the issue with PIEs relates more to the general coherence of New Zealand's rules for taxing savings than to the integrity of the tax system. Accordingly this issue overlaps with our savings policy generally, including KiwiSaver. In particular it may not be desirable to increase tax rates on locked in KiwiSaver PIEs, even if the decision is made to increase rates on other types of PIEs.
69. For this reason officials recommend that PIE-related measures only be considered once tranches one and two have been progressed.

Fiscal impact

70. s 9(2)(f)(iv) 
71. We will report to you on the fiscal impact of the other possible measures when we report on them in more detail.

Process and next steps

72. Officials recommend the following timeframes:
- **First tranche (dividend integrity and income attribution):** Officials would release a discussion document in early 2022 and consult during that year. We would report back to you on the consultation and on our final policy recommendations in the middle of 2022. Depending on the availability of a bill, it could be introduced later in 2022 and enacted with application from 1 April 2023.
 - **Second tranche (trust integrity proposals and further company integrity proposals):** Given the need to review the information gathered from the trust disclosure project, we propose reporting back to you on recommended measures in the second half of 2023. Consultation would follow in 2023 or early 2024, with a bill later in 2024.
73. We could also report to you on possible PIE changes in 2024, following development of the policy for the trust measures.

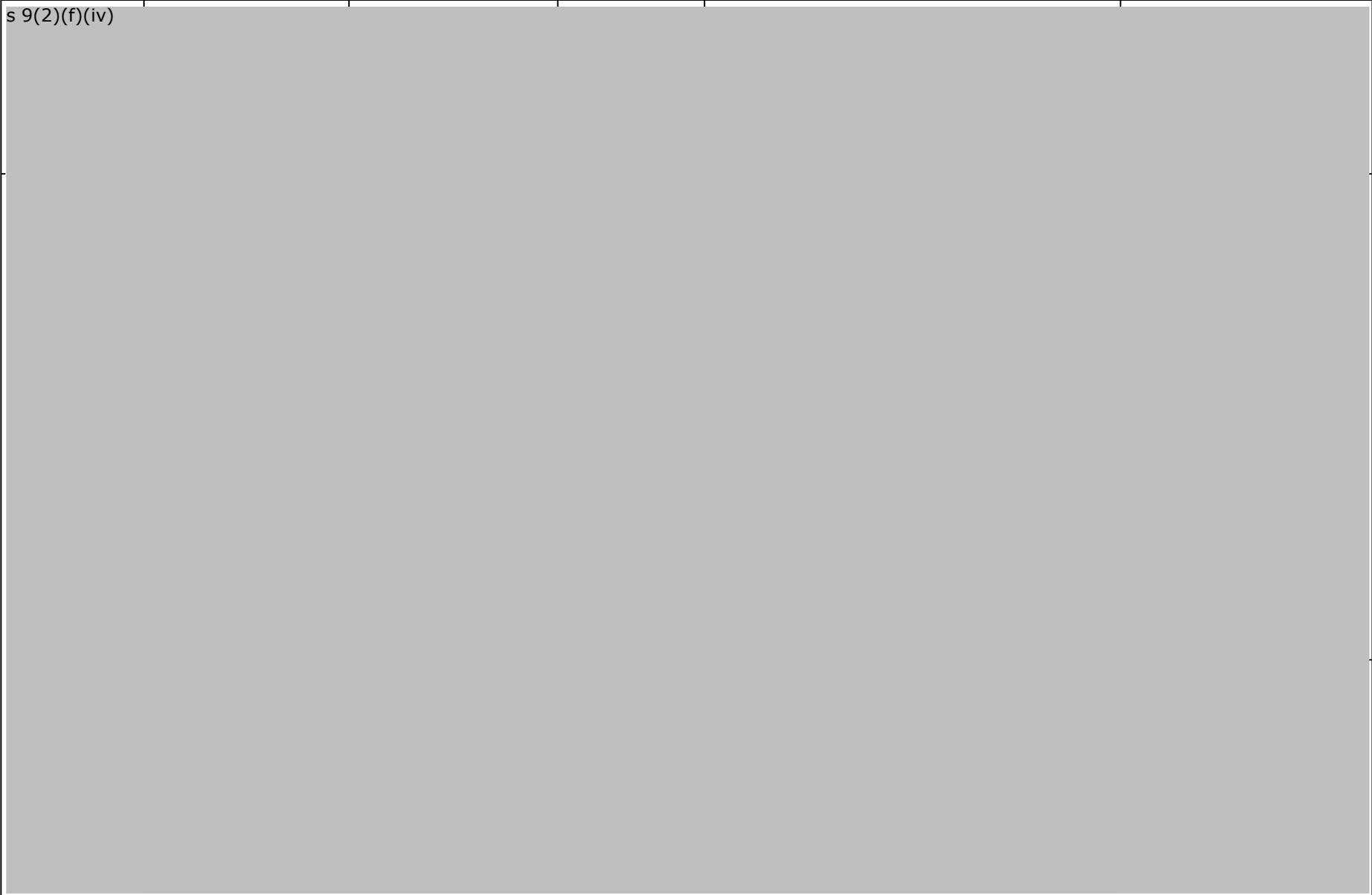
⁴ For example, PIEs are often managed funds that charge fees to the investors. Some investors might normally choose to invest directly and not pay these fees, but a significant tax advantage may result in them using managed funds and paying the fees they would have otherwise saved.

Annex: Description of possible integrity measures

Entity	Integrity issue	Measure	Type of income	Comment	Earliest feable application date
Trusts and companies	Personal services income	Expand the personal services attribution rule	Labour	There is currently a personal services attribution rule that applies when personal services income is earned through a trust or company. However, it is narrowly drafted and rarely applies. Officials could consider whether its parameters could be changed to apply more widely.	1 April 2023
Companies	Dividend avoidance. Amounts distributed out of retained earnings of a company are intended to be taxed at the shareholder's personal income tax rate with imputation credits. There are some ways a shareholder can receive these earnings without paying any tax.	Tax a portion of receipts related to retained earnings when selling shares in a controlled company	All	This would tax a portion of the receipts in more limited circumstances (shares of controlled companies only, and only to the extent of retained earnings). Some countries have measures that do this. This can be viewed as a dividend anti-avoidance measure which is consistent with the policy framework of not taxing capital gains. This project is already underway under the work programme and we recommend that it continue as a high priority next year.	1 April 2023
		s 9(2)(f)(iv) [REDACTED]	[REDACTED]	[REDACTED]	[REDACTED]

		s 9(2)(f)(iv)	

s 9(2)(f)(iv)



		s 9(2) (f)(iv)			