

In Confidence

Office of the Minister of Finance

Office of the Minister of Revenue

Chair, Cabinet Economic Development Committee

RELEASE OF DISCUSSION DOCUMENT – DIVIDEND INTEGRITY AND PERSONAL SERVICES INCOME ATTRIBUTION

Proposal

1. This paper seeks the Cabinet Economic Development Committee's agreement to the release of a discussion document, *Dividend integrity and personal services income attribution*.

Relation to Government Priorities

2. During the 2020 election, the Labour Party announced an intention to establish a new top personal income tax rate of 39% for income earned over \$180,000, which has since been implemented by this Government. Tax rates on other types of taxpayers, including companies and trusts, remain unchanged at 28% and 33% respectively.
3. 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 the discussion document will help to support this objective by limiting the ability of individuals to avoid the 39% rate by diverting their income through entities taxed at a lower rate.

Executive Summary

4. The Government's work on integrity measures to support the 39% personal income tax rate is being progressed in tranches. Tranche one, which comprises the subject matter of the discussion document, concerns dividend integrity and income attribution measures relating to the use of closely-held companies and trusts by relatively high income individuals. Tranches two and three will consider trust integrity and company income retention issues and integrity issues with the taxation of portfolio investment income.
5. The discussion document proposes:
 - 5.1 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.

- 5.2 That companies be required, on a prospective basis, to maintain a record of their available subscribed capital (ASC)¹ and net capital gains, so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation.
- 5.3 That the “80 percent one buyer” test for the personal services attribution rule be removed.
6. I propose that the period for submissions be open for approximately six weeks until Friday 29 April.

Background

7. 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 objectives in relation to fairness and economic efficiency. In particular, high income taxpayers can reduce the amount of their income that is subject to either the 33% personal income tax rate or the new top personal income tax rate of 39%.
8. The tax differences arising from the use of different entities as vehicles for deriving income 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.
9. The tax treatment of distributions from entities to individuals also varies by entity type. In some cases, there are permanent differences in taxes paid.
10. 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). Increased structuring by individuals to avoid the 39% rate may have unintended impacts on:
 - 10.1 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.
 - 10.2 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.

¹ “Available subscribed capital” refers to a company’s paid-up share capital and can be distributed tax free to shareholders on liquidation.

- 10.3 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.
11. 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.
12. 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 the discussion document can affect taxpayers at any personal tax rate in situations where some of or all their income is being earned through entities.

Scope of potential reforms and previous decisions

13. The current tax policy settings are a top personal income tax rate of 39%, a 28% company income tax rate, a 33% trustee rate (pending an upcoming review of the use of trusts to avoid the top personal tax rate) and no general capital gains tax. Any integrity measures should be consistent with these broader settings. This means that the measures should focus on mechanisms that divert the income of a taxpayer on the 39% rate 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%.
14. On the advice of officials from The Treasury and Inland Revenue, the Ministers of Finance and Revenue previously decided to progress the work on integrity measures in tranches. Tranche one, which comprises the subject matter of the discussion document, concerns dividend integrity and income attribution measures relating to the use of closely-held companies and trusts by high income individuals.
15. The policy options considered in the discussion 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. Rather, they would create the potential for a significant amount of income (that is derived by comparatively few families and individuals) to be recharacterised and taxed at the appropriate rate.
16. 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.
17. Income retention measures would address the deferral benefit taxpayers can get from investing through a company (including in cases where eventual distributions are taxed at the 39% rate).

18. 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.

Dividend integrity

19. The discussion 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 Resident Withholding Tax is imposed).
20. 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 the 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.
21. 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 (non-taxable). 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.
22. Secondly, practical issues arise when a company cancels shares or is liquidated. At this point, the company's ASC 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 a share cancellation or liquidation highly problematic.

Personal services attribution

23. The discussion 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%.
24. The personal services attribution rule 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).

25. 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:
 - 25.1 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 in the document as the "80 percent one buyer" rule.
 - 25.2 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.
 - 25.3 "Substantial business assets"² are not a necessary part of the business structure that is used to derive the associated entity's income from personal services.
26. 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.
27. 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 activity. Consequently, the taxpayer should be taxed on their services income at the applicable marginal rate. However, the legal structure used allows tax to be paid at a lower rate.

Proposals in the discussion document

28. The draft discussion document proposes measures to address the issues described above and improve the integrity of the 39% personal tax rate and the dividend definition. It proposes:
 - 28.1 **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 would trigger a residual tax liability for the shareholder. The company should also

² "Substantial business assets" means depreciable property that 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. In the specific 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).

have an increase in its ASC. This ASC increase would address a current inequity in the imputation credit continuity rules and prevent double taxation upon liquidation.

28.2 **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.

28.3 **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.** As outlined above, the 80 percent one buyer rule narrowly targets the personal services attribution rule at taxpayers that are dependent on a single customer (and so are closer to employees). However, as stated above, the problem is not limited to just those taxpayers that are dependent on a single customer. Therefore, there may be a good argument for removing the 80 percent one buyer rule altogether.

29. In relation to the personal services attribution rule, the discussion document also asks submitters whether the thresholds under the “80 percent one natural person supplier” and substantial business assets tests should be revised or updated.

Financial Implications

30. Releasing the discussion document will not have any fiscal implications. Any fiscal implications resulting from the proposals will be included in final policy advice to Cabinet following consultation.

Legislative Implications

31. The release of the discussion document will not give rise to any immediate legislative implications. Legislative changes will be necessary to implement the proposals. It is proposed that any resulting changes are included in an omnibus taxation bill to be introduced in the second half of 2022.

Impact Analysis

Regulatory Impact Assessment

32. An interim Regulatory Impact Statement (RIS) has been completed and is attached in appendix two.

33. The Quality Assurance reviewer from Inland Revenue has reviewed the *Dividend integrity and personal services income attribution* interim RIS prepared by Inland Revenue and considers that the information and analysis summarised in the RIS **partially meets** the quality assurance criteria. This is because the impacts on the affected taxpayers are currently unknown. Consultation on the proposals may help to inform the likely magnitude of the impacts and to refine the design of the proposals to minimise or reduce compliance costs. Inland Revenue will report back to Cabinet

with a final RIS with further information on these impacts when final policy decisions are sought following public consultation.

Climate Implications of Policy Assessment

34. A Climate Implications of Policy Assessment (CIPA) is not required for the proposals in the discussion document.

Population Implications

35. Releasing the discussion document will not have any population implications. Any population implications resulting from the proposals will be included in final policy advice to Cabinet following consultation.

Human Rights

36. The proposals contained in the discussion document are not inconsistent with the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993.

Consultation

37. The Treasury and the Ministry of Business, Innovation and Employment (MBIE) were consulted on this paper.
38. A key priority for New Zealand is lifting productivity including through establishment of high growth firms and innovative start-ups. MBIE agrees with the intention of the policy to remove certain abuses and tax avoidance behaviour of individuals, particularly where they invoice via a company simply to avoid the higher personal tax rate, and/or retain earnings rather than paying themselves a dividend, so as to realise these earnings upon selling the company. However, MBIE is concerned that an unintended consequence of this policy may be to disincentivise the establishment of and investment in start-ups by founders and investors.
39. We would like to understand better whether the tax liability associated with the retained earnings that founders/investors face upon the sale of shares is likely to be higher than that faced in comparable jurisdictions where capital gains taxes would apply and are significantly lower than personal income tax rates (or where tax incentives are in place for such businesses). If so, this could impact both entrepreneurs and early stage investors and the strong positive externalities they bring, or result in unintended consequences where companies rather than keep retained earnings, spend cash at hand immediately prior to the sale (on unproductive assets/uses).
40. MBIE also notes that this policy may have high compliance costs for small business around record keeping and reporting of ASC and capital gains. MBIE would welcome further assessment of potential impacts on, and incentives for, small business and start-ups created by this policy as it is further developed and implemented.

Communications

41. Communications will be undertaken by Inland Revenue. The goal is to gain detailed feedback from the tax and business communities. Key stakeholders will be contacted

and encouraged to make a submission. The discussion document will be hosted on Inland Revenue's tax policy website, with the consultation period open for six weeks until Friday 29 April.

42. Media enquiries will be sent to Inland Revenue's policy communications staff, who will work with Ministers' Offices to coordinate responses.

Proactive Release

43. I propose to proactively release this Cabinet paper, associated minutes, and key advice papers with appropriate redactions within 30 working days of Cabinet making final decisions.

Recommendations

The Ministers of Finance and Revenue recommend that the Committee:

1. note that the Ministers of Finance and Revenue previously decided to progress the work on measures to support the integrity of the 39% personal income tax rate in tranches, with tranche one comprising the subject matter of the discussion document titled *Dividend integrity and personal services income attribution*;
2. agree to the release of the abovementioned discussion document;
3. invite the Ministers of Finance and Revenue to report back to Cabinet on the outcome of the consultation and final policy recommendations in June.

Authorised for lodgement

Hon Grant Robertson
Minister of Finance

Hon David Parker
Minister of Revenue