

Hon Grant Robertson, Minister of Finance

Hon David Parker, Minister of Revenue

Information Release

Dividend integrity and personal services income attribution: release of discussion document

May 2022

Availability

This information release is available on Inland Revenue's tax policy website at <https://taxpolicy.ird.govt.nz/publications/2022/2022-ir-cab-dev-22-sub-0028>

Documents in this information release

#	Reference	Type	Title	Date
1	T2021/277 IR2021/063	Tax policy report	Integrity of the 39% top personal income tax rate	30 September 2021
2	IR2022/013 T2022/106	Tax policy report	Discussion document – Dividend integrity and personal services income attribution	2 February 2022
3	IR2022/075	Tax policy report	Regulatory impact statement – Dividend integrity and personal services income attribution	28 February 2022
4	DEV-22-SUB-0028	Cabinet paper	Release of discussion document – dividend integrity and personal services income attribution	9 March 2022
5	DEV-22-MIN-0028	Minute	Dividend integrity and personal services income attribution: release of discussion document	9 March 2022

Additional information

The Cabinet paper was considered by the Cabinet Economic Development Committee on 9 March 2022 and confirmed by Cabinet on 14 March 2022.

Two attachments to the Cabinet paper are not included in this information release as they are publicly available:

- Regulatory impact statement – Dividend integrity and personal services income attribution (25 February 2022)¹
- Dividend integrity and personal services income attribution – a Government discussion document (March 2022)²

¹ Available at <https://taxpolicy.ird.govt.nz/publications/2022/2022-ris-dividend-integrity-psa>

² Available at <https://taxpolicy.ird.govt.nz/publications/2022/2022-dd-dividend-integrity-psa>

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Sections of the Act under which information was withheld:

- 9(2)(a) to protect the privacy of natural persons, including deceased people
- 9(2)(f)(iv) to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials

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POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

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	12 October 2021
Minister of Revenue	Discuss this report with officials Agree to recommendations	12 October 2021

Contact for telephone discussion (if required)

Name	Position	Telephone
Paul Young	Principal Policy Advisor, Policy and Regulatory Stewardship, Inland Revenue	s 9(2)(a)
Stephen Bond	Acting Manager, Tax Strategy, The Treasury	

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)



Stephen Bond
Acting Manager, Tax Strategy
The Treasury

Paul Young
Principal Policy Advisor
Inland Revenue

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

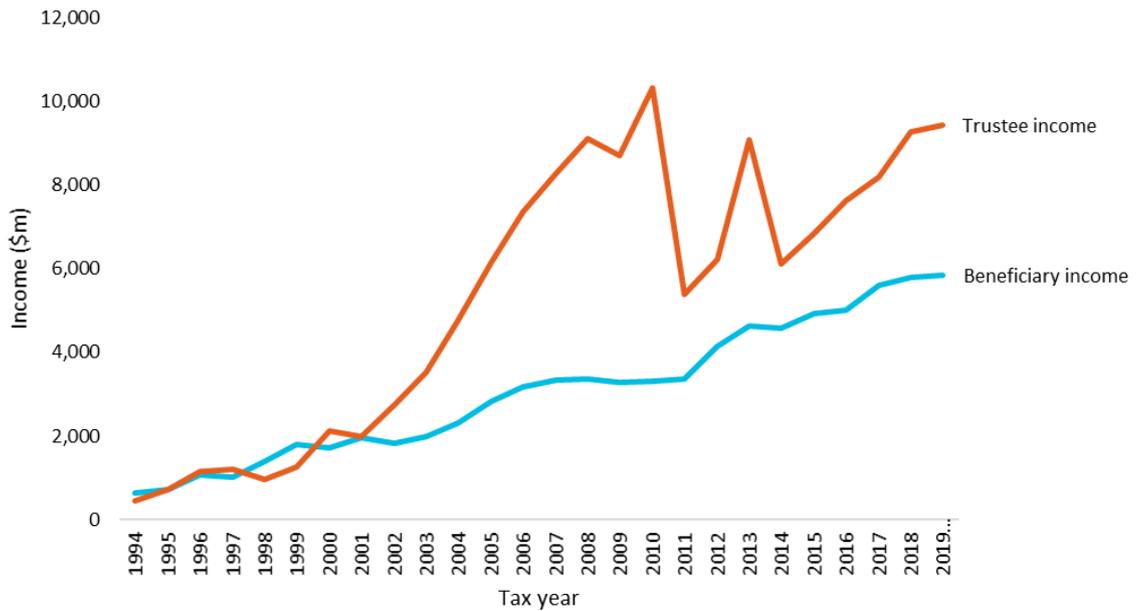
52. There is a risk that high rate taxpayers will use trusts and companies to obtain a lower tax rate on what is really personal services income. This is typically done by incorporating a company to contract for services. The company contracts with the client, and pays the 28% corporate tax rate on its 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

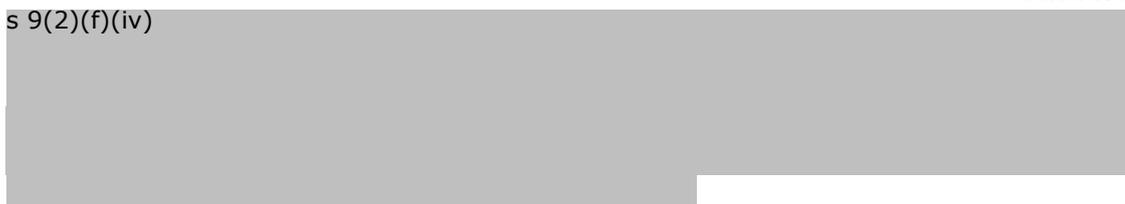


Source: Inland Revenue

- 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. The concern that loans to shareholders may be used to avoid tax on dividends is very much about small and micro companies. It is common for closely held companies to make loans to shareholders. There are some complex tax consequences for loans to shareholders, such as deeming a dividend to arise for underpaid interest if a market interest rate is not charged. If a loan is not repaid, a deemed dividend should arise. However, the deemed dividend may not be identified due to a lack of information by Inland Revenue and an inability of the company to demand repayment of the loan (or even report that the loan exists) after it is struck off. This means that in practice loans can be used to avoid dividend taxation on what is in substance a transfer of value to the shareholder.
64. s 9(2)(f)(iv)



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.

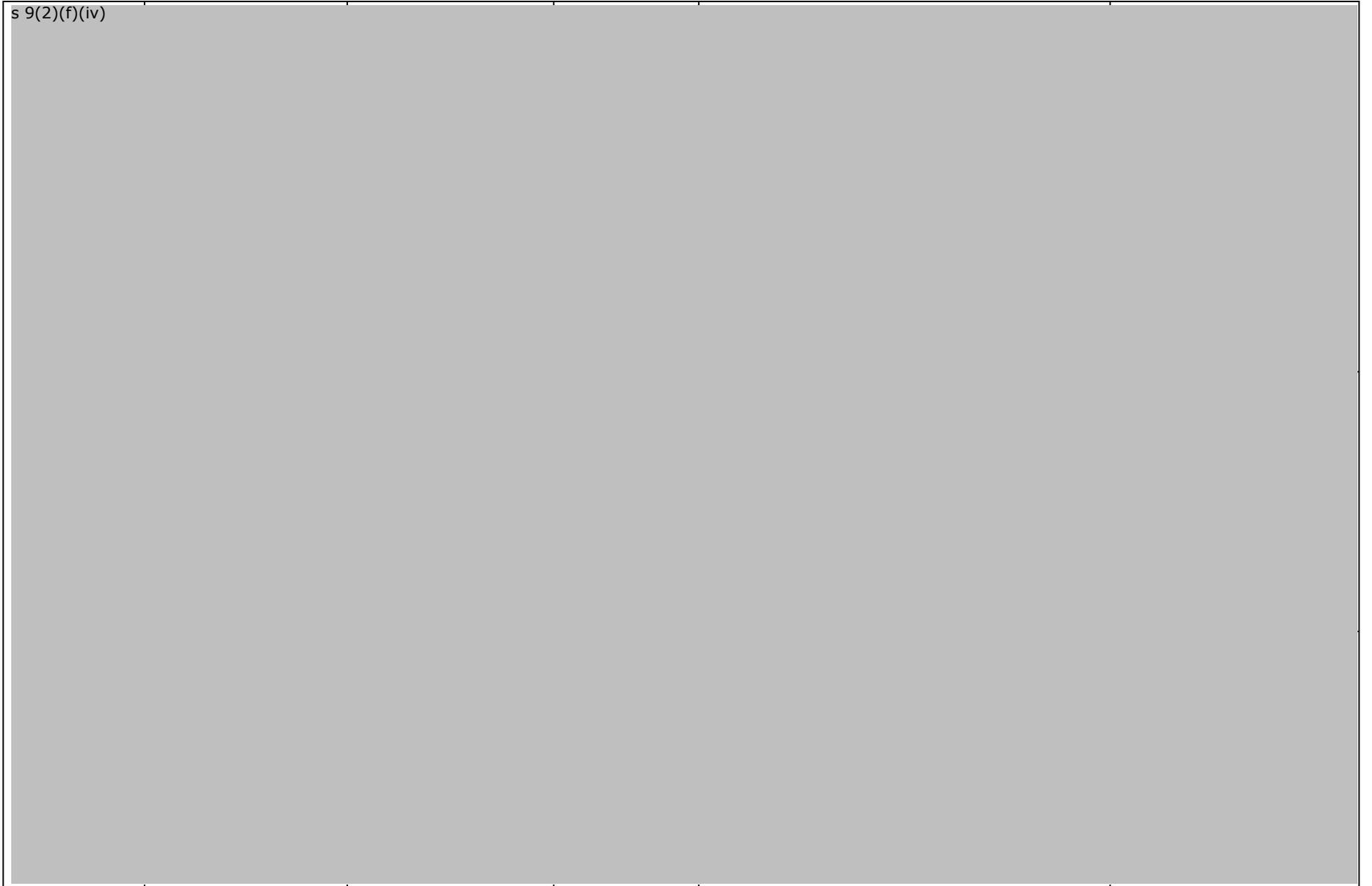
Annex: Description of possible integrity measures

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)					

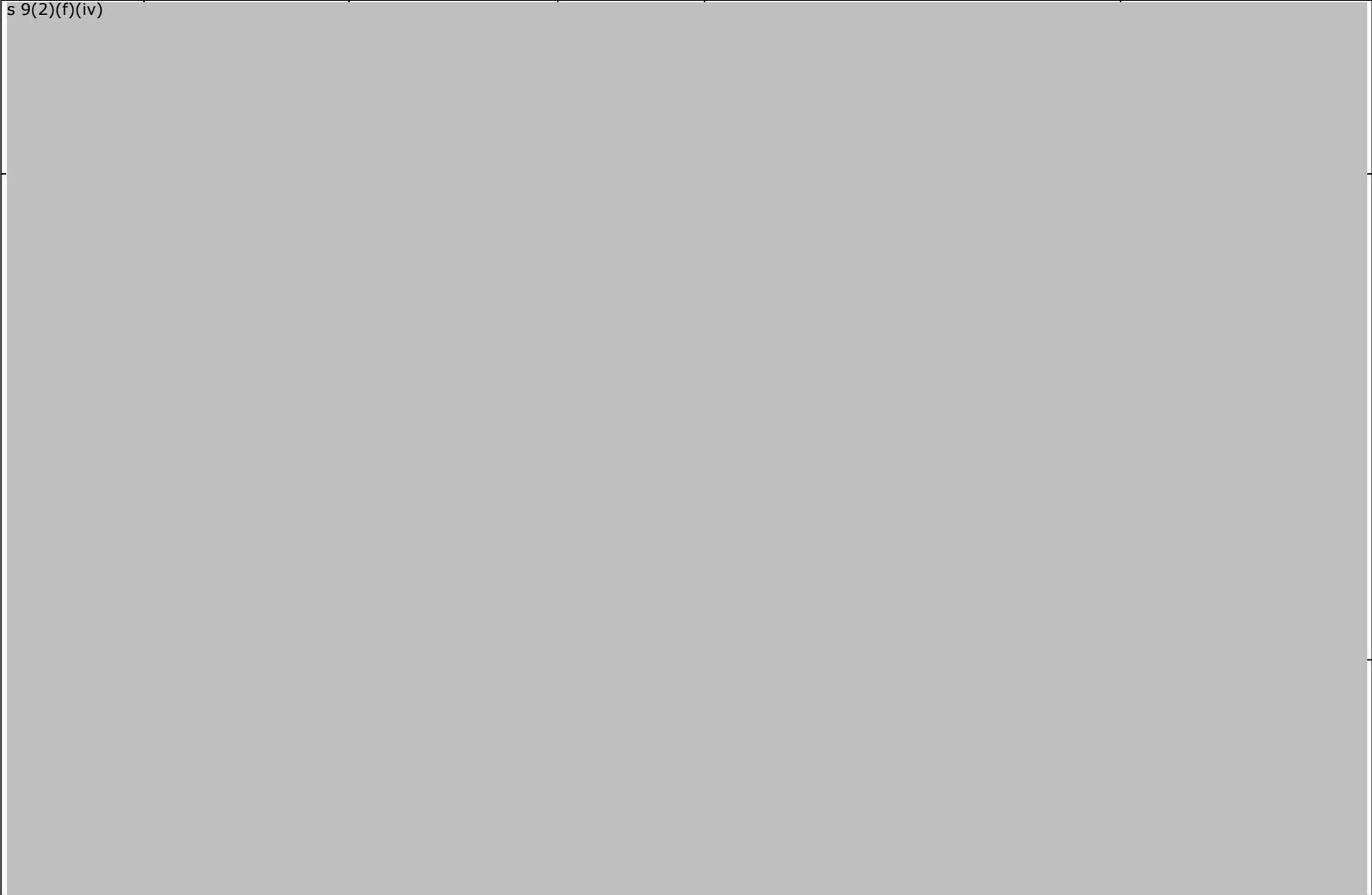
s 9(2)(f)(iv)



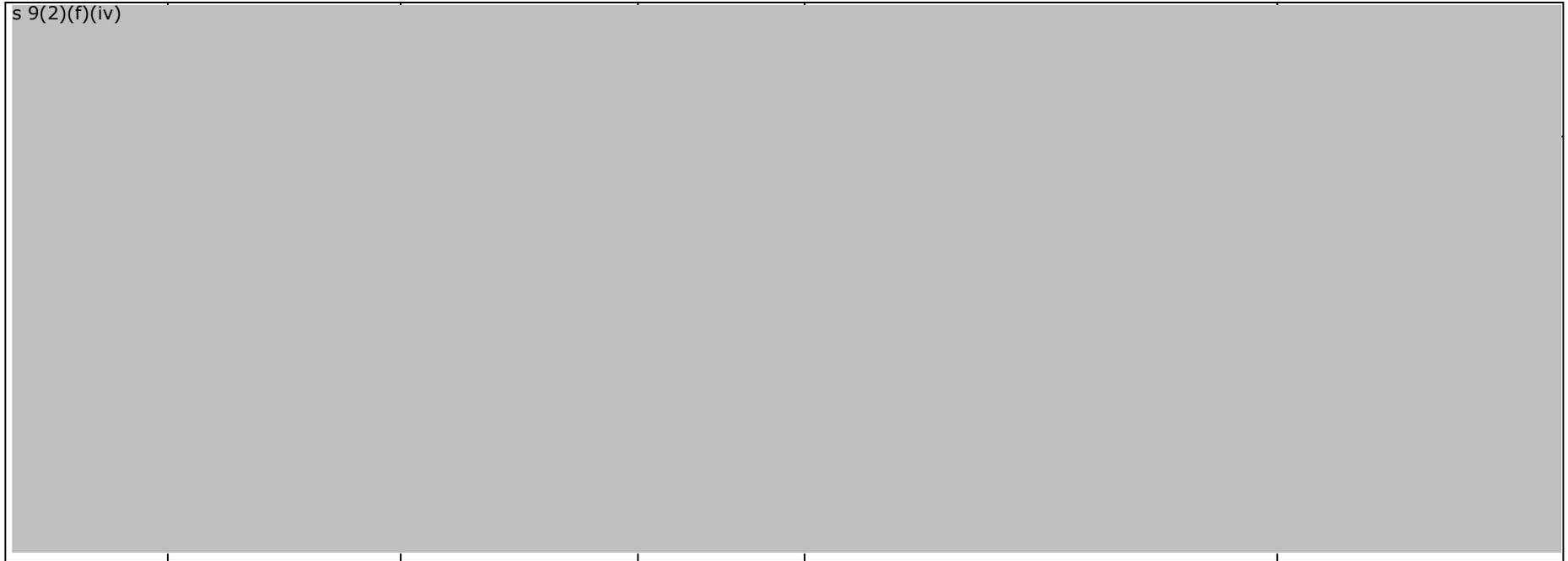
s 9(2)(f)(iv)



s 9(2)(f)(iv)



s 9(2)(f)(iv)





POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

Tax policy report: **Discussion document – Dividend integrity and personal services income attribution**

Date:	2 February 2022	Priority:	Medium
Security level:	In Confidence	Report number:	IR2022/013 T2022/106

Action sought

	Action sought	Deadline
Minister of Finance	Authorise the lodgement of the attached Cabinet paper	10am Thursday 3 March 2022
Minister of Revenue	Authorise the lodgement of the attached Cabinet paper	10am Thursday 3 March 2022

Contact for telephone discussion (if required)

Name	Position	Telephone
Paul Quirke	Senior Analyst, The Treasury	s 9(2)(a)
Paul Young	Principal Policy Advisor, Inland Revenue	

2 February 2022

Minister of Finance
Minister of Revenue

Discussion document – Dividend integrity and personal services income attribution

Executive summary

Purpose

Officials previously reported to you with advice on measures to mitigate integrity risks associated with companies, trusts and Portfolio Investment Entities (PIEs) arising from the new top personal income tax rate (T2021/277; IR2021/063 refers). The report recommended that the streams of work on possible integrity measures be progressed in separate tranches, with the first tranche comprising primarily company integrity measures. This includes dividend integrity and income attribution measures, as well as proposals around recording available subscribed capital (ASC)¹ and net capital gain amounts.

This report, therefore, attaches a draft discussion document and Cabinet paper on these measures for your consideration. Officials are in the process of finalising the discussion document, so the document is still subject to minor editorial changes.

Proposals in the discussion document

The draft 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. 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.
- 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.

Regulatory Impact Assessment

A Regulatory Impact Statement (RIS) is being prepared to assist Cabinet’s consideration of the proposals in the discussion document. Consequently, the Impact Analysis section of

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

the Cabinet paper will change once the quality assurance review of the RIS has been completed. Officials will provide you with the finalised RIS and Cabinet paper in the week beginning 21 February.

Next steps

Subject to your agreement, the discussion document will be released for public consultation in the week beginning 14 March, with public consultation on the proposals open for six weeks. This is with a view to Cabinet considering the final policy on 27 June, with the proposals to be included in an omnibus tax bill planned for introduction in August.

Recommended action

We recommend that you:

1. **authorise** the attached Cabinet paper and discussion document for lodgement with the Cabinet Office.

Authorised

s 9(2)(a)



Stephen Bond

Manager
Tax Strategy
The Treasury

Authorised

s 9(2)(a)



Paul Young

Principal Policy Advisor
Policy and Regulatory Stewardship
Inland Revenue

Hon Grant Robertson

Minister of Finance

/ /2022

Hon David Parker

Minister of Revenue

/ /2022

Purpose

1. This report attaches a draft discussion document and Cabinet paper on dividend integrity and income attribution measures for your consideration.

Context and background

2. Officials previously reported to you with advice on measures to mitigate integrity risks associated with companies, trusts and Portfolio Investment Entities (PIEs) arising from the new top personal income tax rate (T2021/277; IR2021/063 refers). The report recommended that the streams of work on the possible integrity measures be progressed in separate tranches, with the first tranche comprising primarily company integrity measures. The attached discussion document contains proposed measures arising out of officials' work on tranche one, and includes dividend integrity and income attribution measures.
3. Officials are in the process of finalising the discussion document, so the document is still subject to minor editorial changes.

Dividend integrity

4. The 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).
5. 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.
6. 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.
7. 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 a share cancellation or liquidation highly problematic.

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

Personal services income attribution

8. The 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%.
9. 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).
10. 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:
 - 10.1 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.
 - 10.2 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% one natural person supplier" rule.
 - 10.3 "Substantial business assets"³ are not a necessary part of the business structure that is used to derive the associated entity's income from personal services.
11. 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.
12. There is a risk that other taxpayers on the 39% personal tax rate who are not currently subject to the personal services attribution rule 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 in effect 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.

³ "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).

Proposals in the discussion document

13. 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. In particular, it proposes:
 - 13.1 **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 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.
 - 13.2 **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.
 - 13.3 **That the “80 percent one buyer” test for the personal services attribution rule be removed.** As outlined above, the 80 percent one buyer test 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.
14. Each of these proposals is independent of the others, though the second would be a useful support for the first, as well as for current law.
15. The discussion document also canvasses the following issues in relation to the personal services attribution rule:
 - 15.1 In some circumstances, the “80 percent one natural person supplier” test might 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 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 from the working person, rather than a significant change in intended scope.
 - 15.2 The threshold for the substantial business assets test 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. Officials note that any increase in the threshold will not affect taxpayers whose business assets cost more than 25% 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.

16. The draft discussion document suggests two possible options for increasing the threshold:
- 16.1 **Option one:** The lower of \$200,000 or 25% of the associated entity's income from services for the income year, excluding the cost of passenger or luxury vehicles unless the entity's business is a transportation business.
- 16.2 **Option two:** The lower of \$150,000 or 25% of the associated entity's income from services for the income year, excluding the cost of passenger or luxury vehicles unless the entity's business is a transportation business.

Financial implications

17. The fiscal impact of the changes will depend on the options that are proceeded with following consultation. Officials will provide an estimate of the fiscal impact in the report on submissions due in May. The report will seek final policy approval of the options developed and will include a draft Cabinet paper.

Regulatory Impact Assessment

18. A Regulatory Impact Statement (RIS) is being prepared to assist Cabinet's consideration of the proposals in the discussion document. Consequently, the Impact Analysis section of the Cabinet paper will change once the quality assurance review of the RIS has been completed. Officials will provide you with the finalised RIS and Cabinet paper in the week beginning 21 February.

Next steps

19. Officials propose the following timeline for releasing the discussion document and obtaining approval of the final policy following public consultation:
- 9 March – Cabinet Economic Development Committee (DEV) considers discussion document release.
 - 14 March – Cabinet approval of discussion document release.
 - 29 April – Submissions on discussion document close.
 - 26 May – Officials report to Ministers on submissions and final policy recommendations.
 - 22 June – Consideration by DEV.
 - 27 June – Cabinet approval of final policy.
 - July/August – Cabinet approval for including proposals in omnibus tax bill.



POLICY AND REGULATORY STEWARDSHIP

Tax policy report: **Regulatory Impact Statement – Dividend integrity and personal services income attribution**

Date:	28 February 2022	Priority:	Medium
Security level:	In Confidence	Report number:	IR2022/075

Action sought

	Action sought	Deadline
Minister of Finance	Note the contents of this report	3 March 2022
Minister of Revenue	Note the contents of this report	3 March 2022

Contact for telephone discussion (if required)

Name	Position	Telephone
Paul Young	Principal Policy Advisor	s 9(2)(a)
Shanae Sherriff	Senior Policy Advisor	

28 February 2022

Minister of Finance
Minister of Revenue

Regulatory Impact Statement – Dividend integrity and personal services income attribution

Purpose

1. This report encloses a Regulatory Impact Statement (RIS) to be considered by the Cabinet Economic Development Committee at its meeting on 9 March 2022, along with the paper *Release of discussion document – Dividend integrity and personal services income attribution*. The final copy of the Cabinet paper, which now includes the Quality Assurance reviewer's comment and an agency comment from the Ministry for Business, Innovation and Employment, is also attached to this report.
2. Only minor editorial changes and Minister Parker's changes have been made to the discussion document since we last reported to you (IR2022/013 refers). The discussion document is currently being formatted and a final copy will be provided to your Office before the lodgement due date on 3 March.

Regulatory Impact Statement

3. The Quality Assurance reviewer from Inland Revenue has reviewed the RIS 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.
4. Following public consultation, officials will provide you with a final RIS with further information on these impacts when final policy decisions are sought.

Recommended action

We recommend that you:

1. **note** the attached RIS and Cabinet paper.

Noted

Noted

s 9(2)(a)



Paul Young

Principal Policy Advisor

Policy and Regulatory Stewardship

Hon Grant Robertson

Minister of Finance

/ /2022

Hon David Parker

Minister of Revenue

/ /2022

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



Cabinet Economic Development Committee

Minute of Decision

This document contains information for the New Zealand Cabinet. It must be treated in confidence and handled in accordance with any security classification, or other endorsement. The information can only be released, including under the Official Information Act 1982, by persons with the appropriate authority.

Dividend Integrity and Personal Services Income Attribution: Release of Discussion Document

Portfolios **Finance / Revenue**

On 9 March 2022, the Cabinet Economic Development Committee (DEV):

- 1 **noted** that on 23 November 2020, Cabinet agreed to implement a new personal income tax rate of 39 percent for income over \$180,000 [CAB-20-MIN-0484];
- 2 **noted** that the Minister of Finance and the Minister of Revenue have decided to progress work on measures to support the integrity of the 39 percent personal income tax rate in tranches;
- 3 **noted** that the discussion document *Dividend Integrity and Personal Services Income Attribution* (the discussion document), attached to the paper under DEV-22-SUB-0028, relates to tranche one of this work;
- 4 **agreed** to the release of the discussion document, subject to any minor or editorial changes that may be required;
- 5 **invited** the Minister of Finance and the Minister of Revenue to report back to DEV on the outcome of the consultation and with final policy proposals, in June 2022.

Janine Harvey
Committee Secretary

Present:

Hon Grant Robertson (Chair)
Hon Dr Megan Woods
Hon David Parker
Hon Nanaia Mahuta
Hon Poto Williams
Hon Kris Faafoi
Hon Willie Jackson
Hon Michael Wood
Hon Meka Whaitiri
Hon Phil Twyford
Rino Tirikatene MP
Dr Deborah Russell MP

Officials present from:

Office of the Prime Minister
Officials Committee for DEV