Inland Revenue

Information Release

Public submissions received on Inland Revenue's discussion document titled *Dividend integrity and personal services income attribution*

December 2022

Availability

This information release is available on Inland Revenue's tax policy website at https://taxpolicy.ird.govt.nz/publications/2022/2022-ir-dividend-integrity-psa-submissons

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38	Ctas NZ Ltd	6 May 2022
39	Peter and Karen Manson	9 May 2022
40	Chapman Tripp	9 May 2022

Additional information

The information release is of the submissions received on the discussion document *Dividend integrity and personal services income attribution*.

Information withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act). Where this is the case, the relevant sections of the Act that would apply are identified. Where information is withheld, no public interest was identified that would outweigh the reasons for withholding it.

Sections of the Act under which information was withheld:

9(2)(a) to protect the privacy of natural persons, including deceased people

Accessibility

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email to policy.webmaster@ird.govt.nz
Subject: "Dividend integrity and person services income attribution"

Submitted by
Name: Melanie Kilfoyle
email: s 9(2)(a)
Phone
Postal

Permission:
Yes, officials from Inland Revenue may contact me to discuss any of these comments if required.

Summary:

- The controls in relation to share sales may be heavy handed and also unnecessary.
- The rules regarding shareholder continuity in relation to imputation credit accounts does, to a large extent, achieve the desired effect without needing to create new laws.
- As an alternative to the proposed rules regarding ASC, it might be worth requiring the company directors to retain a copy of each year's financial statements for the life of the company, thus ensuring the necessary information is to hand if needed.
- The income of high-income individuals does not often come from personal services. Consequently, changing the income attribution rules is unlikely to impact the taxpayers you want to target.
- The proposals seem to be premature, and based on incomplete evidence, since the new top marginal tax rate only affects 2022 income tax returns and very few of those have been filed to date.
- A de minimis threshold the deemed dividend rules would be good (for example, the rules could apply only to share sales with value of $1M or more)
- It might be worth finding an older accountant or economist who can remember how the excess retention tax from the 1980's worked.

Detailed comments:
In general, the NZ tax system's reliance on voluntary compliance seems to be fairly reasonable. Although there will always be a few individuals that will do their best to avoid paying their fair share of tax, the majority are compliant. Using heavy handed legislation to force obedience, when taxpayers are already obeying the spirit of the law, may increase compliance costs without actually increasing compliance to any measurable degree.

Has any research been done into the frequency of share sales in close companies? It may be that a law is being proposed to resolve a problem that is very small.

In general, we have found that the shareholder(s) proposing to sell shares in a close company will encourage that company to declare a dividend prior to the sale. The objective of such dividend would be to pass the retained earnings to the shareholders who have been involved in the company while those profits were earned. The effect is actually to achieve the goal of this proposed law – it passes the earnings of the company through to the company shareholders so that they are forced to pay tax on it at the appropriate marginal tax rate.   Continuing to have the continuity rules in relation to retaining Imputation Credits should be sufficient to achieve the desired effect, making additional legislation unnecessary.

Do you really need a law to force the maintenance of records of Available Subscribed Capital (ASC) and net capital gains? This seems as though you are simply forcing additional compliance costs on small businesses in advance of an event that might never happen. The rules about ASC are robust enough as they stand. It seems more sensible to expect that the exercise be done at the time of share cancellation or liquidation. It is already acknowledged that some extra effort is needed at this time. The required information won't be impossible to compile, if and when it is needed.

Paragraph 1.4 seems to show little faith in taxpayers in general. It seems more likely to me that taxpayers who have been compliant all along will continue to be compliant, regardless of what they think other taxpayers are doing. If you genuinely think that the perception of avoidance is an issue, then perhaps a media campaign (or even some sneaky little updates on the IRD website) showing how IRD is catching and punishing the miscreants might be more effective.

Perhaps you could find some older professionals to consult, who can remember how the anti - avoidance measures of the 1980's worked. In particular the excess retention tax was a good one, and the National Super Surcharge was a very effective (although much reviled) tool for means-testing government support.

The advantage of arbitrage is generally only temporary. In general, if taxpayers wish to spend the money earned by their company, the company must pass that income through to the shareholder so that it is taxed at the individual marginal tax rate.   Income that is left in the company may be taxed at 28% this year, but it is normally only a short number of years before the shareholder wants to spend the money and therefore concedes that it must be passed through as either a dividend or a salary.

While it is tempting to leave some income in the company, the disadvantages associated with an overdrawn current account do tend to encourage the company to distribute the income. In particular, the FBT rules regarding low interest loans encourage compliance. Those who trade as a company in order to have the security of Limited Liability will also try to avoid having overdrawn current accounts. Any company that needs to borrow money will tend to find that lending institutions prefer companies whose shareholders are invested in the company (as opposed to companies that are lending money to their shareholders by allowing them to overdraw their current accounts).

It is hardly surprising that Figure 1 doesn't show any bunching at the $180,000 level. That top marginal tax rate was not in place for the year ended 31 March 2020. It only takes effect from 1 April 2021.

Paragraph 1.12 says there was increased avoidance of the top personal tax rate in 2020 in response to the increase in the top personal tax rate. That is odd, since the tax rate didn't increase in 2020.

The first paragraph under heading 1.13 doesn't read very clearly. Also, the courts have been effective in finding tax avoidance (see Penny & Hooper for example)

You mention the use of PIEs as an area where there is potential for integrity issues to arise. Could that be addressed by adding a further (higher) approved PIR?

Paragraph 1.24 suggests the sale of shares as a way of realising cash from a company. This is a fairly short-sighted way of realising cash, as it ends or severely limits the shareholder's right to any further income from the company.

In response to paragraph 1.25, I would like to ask what research has gone into the pervasiveness of this issue. I would argue that a sale of shares is not a very common transaction and may be unworthy of legislative control. In general, a person interested in buying a business is more likely to buy the business activity (as a going concern) from the company.

The purchase of close company shares is normally discouraged by most advisors. In buying shares, the purchaser is also buying the history of the company. There can be a number of issues in the history of a company that will not necessarily come to light during due diligence but can cause costly problems to a subsequent owner. A couple that spring to mind are retained earnings that include related party capital gains, and historic share buy backs that have used up all of the available subscribed capital. A company may have been a Loss Attributing Qualifying Company (LAQC) or Qualifying Company (QC) at some time in its past. There may be inadvertent errors in recording Imputation Credit account transactions, or a history of having had tax debt forgiven. None of these possibilities are implausible, and therefore many advisors would discourage their clients from buying company shares in order to obtain a new business.

Please, if you really think there is a need for the records described in paragraph 1.26, do make it easy for the small business person. Perhaps you could insist that the company's annual financial statements be retained for the life of the company. This would simply be an extension of the current requirement to hold accounting and tax records for seven years. A company already has to have annual financial statements prepared in order meet income tax and Companies Act requirements. To actually retain a permanent copy of those accounts shouldn't require too much extra cost or effort for the directors. By doing this, the information needed to determine the ASC and other necessary information will be available should it be needed, without putting too much extra burden on business operators.

At 1.28 it is proposed that taxpayers providing personal services are an area of risk. This could do with a bit of research. I think you will find that the high-income people are not generating their high levels of income from personal services. In general, higher incomes are obtained by leveraging other people's labour, or by investing in income generating assets. The amount a taxpayer can earn from personal services is effectively restricted because there is a physical limit to the number of hours a person can work in a day. In my opinion, tinkering with the legislation will add complexity and frustration without noticeably improving the tax take.

1.30: you ask whether the 80% threshold should be dropped to 50%. I think dropping it to 67% would be sufficient.

1.30: you ask about the substantial business assets test. In my experience (I have worked in Chartered Accountancy practices for around 30 years), I have not encountered any companies that have been able to take advantage of the substantial business assets test. I don't think a change in the threshold would make any difference.

2.13 Is there any need for the inter-corporate dividend exemption? Perhaps that should disappear? That might help towards the issues you want to resolve. I'm revealing my prejudices here – I am much more in favour of reducing complexity rather than adding extra new laws.

2.23 This sems counter-intuitive, and contrary to current experience. I have found that more dividends have been declared in the two years leading up to the onset of the higher top marginal tax rate.

The 2021/22 tax year is the first full year where the higher marginal tax rate has applied. Very few of the 2021/22 company tax returns will have been filed yet, since the standard 2021/22 year is not finished. You have very little evidence to support this proposal.

2.26 It seems that you are most concerned about share sale activities where the effective ownership of the company doesn't change. It might be better if your proposal was targeted to these types of transactions rather than a scatter-gun approach targeting all share sales.

3.1 The general scope of the rule appears to recharacterize a sale of a capital asset as a taxable sale, thereby imposing a tax on capital gains without calling it a capital gains tax. There's not much wrong with a capital gains tax, but this is stealthy.

Example 1: No, the Imputation Credits (IC's) are not still available. A 100% sale of shares breaches the continuity rule for retention of IC's.

In example 2 you say that the purchaser has the potential to distribute the $72. It doesn't look like a distribution to me. It looks as though Purchaser Ltd is repaying (to the shareholder of Purchaser Ltd) the cash that the shareholder had loaned to the company so that it became able to achieve the purchase. Repaying a loan should not be counted as a distribution. There is no need to determine whether this is labelled as a taxable or non-taxable distribution.

You ask: To which scenarios should a generic recharacterisation rule apply? In my opinion, **only** the sale of shares where the original shareholder retains effective control of the new owner should be captured. All of the others are not the result of attempted evasion but simply normal commercial decisions made when selling a business.

I think the proposal is unnecessary. Most of the intended result is actually achieved by the rules associated with Imputation Credit accounts and continuity rules. This encourages companies to declare dividends before undertaking any shareholding changes that would otherwise result in the IC's being lost.

3.31 Using the accounting concept of retained earnings is fine. Don't forget that companies are held to a fairly high standard of accounting reporting by the Companies Act. In addition, IRD regulations specify what information must be recorded when using Special Purpose reporting concessions.

3.32 Woohoo! I think that referral to the company's ICA balance is a great idea. Very simple, which is what you want to achieve with any new law. It should be clear and easy to understand and not easy to misinterpret.

3.34 No thanks. I think it would be better to make the undistributed earnings portion be the lesser of the two figures.

3.38 (to treat the deemed dividend as an increase to ASC) seems unnecessarily complicated.

It is quite difficult to follow what you expect the effect to be for the remaining shareholders. It seems (and I'm happy to be corrected here, because I would rather be wrong on this count) that the deemed dividend effectively gives the benefit of accumulated ICs to the seller. The remaining shareholders will lose the advantage of the IC's that had accumulated in the company's ICA.

Questions for Submitters:

- **Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?**

  I can understand the desire to do so, but I think it is unlikely to capture very many transactions. I think the return you will achieve will not be worthy of the effort

- **Should the scope of the proposed recharacterisation rule cover all of scenarios A, B, or C, or only one or two of these scenarios?**

  I think only scenario A (sale to related parties) should be captured. Scenarios B and C have more commercial reality because there is a third party involved and the purpose is not tax avoidance.

- **Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?**

  It's about right.

- **Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?**

  Yes

- **What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two), and which of these approaches do you prefer? Is there an alternative approach you would suggest?**

  I prefer accounting retained earnings, principally for simplicity. The more complicated a tax law is, the more likely it is to be misunderstood, misinterpreted or ignored.

Questions for submitters in relation to ASC and ACDA

- **Whether the proposed transitional rule is appropriate.**

  It doesn't seem unreasonable. However, it might be better to allow taxpayers to calculate the opening balance based on available information. To distinguish between ASC from before the tracking rules started and ASC from after seems complex and unnecessary. Just continue to rely on voluntary compliance, and assume that the "before" ASC is correct.

- **Whether the Commissioner should be able to reopen a return and on what basis.**

  I think a return should only be subject to being re-opened
  a) when ASC is used (for example when a share buy back is actioned) AND
  b) when it is material.

Share buy backs or other use of ASC that are less than $100,000 are ridiculously small and would not generate enough benefit for the time IRD has to commit to such investigations. A threshold of $1,000,000 might even be appropriate.

- **Whether the proposal strikes an appropriate balance between compliance costs and tax integrity.**

  No it does not. It imposes additional compliance costs on all companies. This might be appropriate if this was a big problem, but it is not a big problem. Perhaps this rule should apply only to listed companies?

- **Whether the ASC and ACDA memorandum accounts should be reported in annual returns.**

  No, I don't think it should be disclosed in income tax returns. But maybe, if you really think it is important, perhaps the Special Purpose Reporting rules for Tax Purposes could be modified in order to require that that the ASC is disclosed in a note to the financial statements.

5.3 **If these accounts are not prepared on a timely basis** … This seems unnecessarily punitive. Most taxpayers do try to be compliant but there are many reasons (including death or serious illness, or pandemic lockdowns) that might prevent the records being prepared on a timely basis. The TAA already has enough powers to encourage filing returns on a timely basis. There is no need to add to this.

The second is to require taxpayers to keep and maintain these accounts …but without requiring taxpayers to submit these accounts to Inland Revenue. Yes, this is the better option.

… maintain sufficient records to evidence the amounts entered in the ASC and ACDA memorandum accounts… do you have any thoughts on what kind of evidence you want here? The phrase sounds nice, but it is rather vague. Perhaps a copy of the financial statements for the relevant year (showing that there genuinely was some kind of activity that increased the ASC) would be sufficient.

5.7 … compliance with a requirement to maintain tracking accounts could be optional, on the basis that companies that do not choose to maintain accounts would then have no ASC or ACDA

It seems to me that the need to prove ASC or ACDA would arise only on very rare occasions. Perhaps the companies that choose not to maintain such accounts could be permitted to reconstruct the records to prove the ASD balance, if and when the need ever arises.

I can see that you want to provide for a greater level of proof. However, it really seems that you are asking a lot of extra record keeping for all companies, when the majority of them may never need to use the ASC balance at all. It seems quite an onerous addition to the responsibilities of small business people.

5.11 **… would be onerous.** I totally agree!

Personal services income attribution

I suspect that an excess retention tax (like there was in the 1980's) would be more effective in attaining your stated goal.

Example 8: did you check before you wrote the example whether there is actually accompany called A Plus Accounting Ltd? It might be a bit rascally to be appropriating the name of a real business for your example.

Your questions:

- **Do you agree with the proposed removal of the "80 percent one buyer" test? Why/why not?**
  The proposal is probably fair, but I don't like it.

  Do you agree with the suggested decrease in the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?
  I can see your reasoning. You are trying to expand the scope of the personal service income rule to cover more than just a structure that is close in nature to employment. The goal is clearly to ensure that more income is passed through to shareholders, to be taxed at 39% rather than being retained by companies to be taxed at 28%.

  This seems to target one small corner of the self-employed market, while leaving others (for example where there are employees as well as a principal, or where personal services are mixed with sale of goods, such as tradesmen) untouched. I prefer a level playing field which is why I would recommend something more general and wide-ranging like excess retention tax.

- **Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?**
  I don't see any need to change the thresholds. This rule doesn't have much impact, and changing it won't make much difference.

- **Do you consider the net income threshold should be increased from $70,000 per year to $180,000?**
  Yes

My question for you: has the 21 June 2020 Revenue Alert on Diverting Personal income been superseded? This alert encourages close companies to pay a market salary to shareholder(s) for personal services rendered.

SPEAKMAN LAW

29 March 2022

Deputy Commissioner.
Policy and Regulatory Stewardship
Inland Revenue Department

By email: policy.webmaster@ird.govt.nz

RE: Dividend Integrity and Personal Services Income Attribution – Submissions

1. Introduction

I have pleasure in providing these submissions on the Government's discussion document entitled "Dividend Integrity and Personal Services Income Attribution", published in March 2022 ("the Discussion Document").

2. Executive Summary

It is the writer's respectful opinion that:

a) The proposal to deem a dividend to arise when shares are sold (while the company has retained earnings) is **not** an appropriate policy outcome;

b) If the proposed recharacterisation is to proceed, its scope should be limited to scenario A;

c) If the proposed recharacterisation is to proceed, its scope should be narrowed;

d) The conceptual basis for quantifying the deemed dividend is too broad, and fails to appropriately reflect multiple tax settings throughout the Income Tax Act 2007 ('Tax Act'), including, to name a few, the exemption for dividends received from a foreign company in section CW9 of the Tax Act, tax exemption on income received from investment in PIEs, attributed FIF income and amounts received from a trust on which tax has been paid as trustee income;

e) The purposes underpinning the proposals in Part 1 of the Discussion Document are better delivered, in the writer's opinion, by adopting one or more of the measures in Section 5 of these submissions.

f) Proposed amendments to the Personal Services income attribution rules are too broad.

3. Broad Effect of the Dividend Integrity Prospects is too Wide

The broad effect of the proposal to deem a dividend to arise upon sale of shares in a company which has retained earnings is to tax those retained earnings at the seller's marginal tax rate at the time of the share sale transaction (reduced by available imputation credits).

This accelerates the point of time at which the retained earnings are taxed at the shareholder level and represents a substantial, and in my view unwarranted, erosion of the form of a company as an entity through which business is conducted.

The concern underpinning the acceleration of this timing point appears to be that existing dividend stripping rules suffer from uncertainty. The proposals respond to this concern, essentially by removing the requirement in the dividend stripping rules for a tax avoidance arrangement to be established. Instead, the proposals presuppose that in all cases where a controlling shareholder sells his, her or its shares, concern about possible tax leakage warrants acceleration of the tax liability on the company's retained earnings at the shareholder's level.

This concern about possible tax leakage lumps genuine third party sale arrangements in together with related party sale arrangements, which are seldom motivated by tax avoidance. By adopting this wide breadth of application:

a) There is essentially a look through of the company's tax position, akin to that of a partnership or look through company (albeit the trigger for look through is occasioned only by a share sale transaction); and

b) Amounts that the seller would naturally (particularly in a third party sale transaction) presume to be capital receipts are taxable notwithstanding the absence of a formal capital gains tax system. This is somewhat counterintuitive and contrary to principles of clarity inherent in a tax system that distinguishes capital receipts from income receipts and, rightly or wrongly, chooses not to tax them.

In summary, it is my respectful opinion that the scope of the dividend integrity proposals is too broad. Their scope should be limited in one or other of the manners suggested in section 5 of this letter.

4. Dividend Integrity Proposal – Conceptual Approach Mistaken

The dividend integrity proposals can, in concept, be viewed as attributing a company's retained earnings balance to a selling shareholder (where the sale is made by a controlling shareholder). As noted above, this disregards the company form in favour of a substance approach that treats a company as the agent or alter ego of its shareholders. It is neither. It is a separate entity and its form should be recognised for tax purposes, as it is in company law.

Attributing a company's retained earnings to its shareholders essentially, entails flow through tax treatment to the selling shareholder, triggered by the sale of that shareholder's shares. There are significant problems with this conceptual approach.

Consider the following examples:

a) Company owns shares in an overseas company and receives a dividend. That dividend is exempt in the hands of the recipient under section CW9. The proposal will impose a tax liability on the amount of the foreign dividend in proportion to the shares in the company that are being sold (100% if all the shares are being sold);

b) Company has an investment in a PIE: the tax paid by the PIE is intended to be a final tax and the income from it is excluded income. The proposals will, however, result in this excluded income being taxed in the hands of the selling shareholder, in proportion to the shares in the company that are being sold;

c) Company is beneficiary of a trust and receives tax paid income from the trust: Precisely the same consequences will arise as described in paragraph (b);

d) Company has a FIF and applies the FDR method of calculation of attributed FIF income. Amounts received by the Company from the FIF, insofar as they exceed amounts attributed as income under the FDR method, will suffer the same tax consequences as described in paragraph (b) above;

e) Company with tax losses. Where a company has tax losses available to it, its retained earnings balance will be improved by the amount of tax on its income that is satisfied by applying the tax losses against it, instead of a cash payment in payment of the tax. The proposals will result in the improved retained earnings balance being taxed at the shareholder level, effectively cancelling out the benefit of the tax losses.

In each of these circumstances, the Company will not have an imputation credit to shelter the addition to its retained earnings balance on account of the amounts received (or amount retained in the case of a company with tax losses that applies them against its income). They are all consequences that would arise on a liquidation of the company. The proposals do not seek to effect or replicate the result of a liquidation (or partial liquidation) but nonetheless accelerate the tax liability.

Two further areas of concern are:

a) Companies with an imputation credit balance but no retained earnings (the retained earnings balance having been exhausted by losses suffered in years subsequent to years of profit during which tax was paid on imputation credits generated);

b) The impact of the proposals on employee share schemes.

Dealing with the first of these two concerns, by quantifying the deemed dividend as the higher of the company's accounting retained earnings and the company's ICA balance divided by the company tax rate, a tax liability will arise for a selling shareholder in relation to an amount that the proposals presume to be available to be paid by the company to that shareholder as a dividend. That presumption is incorrect; in these circumstances there is no amount available to the company to pay as a dividend.

Dealing with the second of these concerns, wherever an employee share scheme is established with shares contributed by the controlling shareholder (which is common in a succession planning setting), a tax liability will arise for the selling shareholder (assuming the company has a retained earnings balance). This may prove to be an obstacle to commercially motivated employee share planning.

5. Targeting the Dividend Integrity Proposals

As discussed earlier in these submissions, the dividend integrity proposals supplant the requirement to establish a tax avoidance arrangement in order to apply the dividend stripping rules with an all pervasive taxation of a company's retained earnings balance upon sale of a controlling shareholder's shares.

For reasons already discussed, the author believes this is not a good policy setting. Instead, it is my view that the proposals, if they are to be pursued, ought to be targeted at sale transactions that have the hallmarks of a tax avoidance arrangement. It might be sensible, for example, to replicate the active/passive business test that is used in the CFC attribution rules. A company with passive activities only, might for example be subject to these proposals and a company with an active business might be excluded from them. Another possibility may be to afford a company with an active business the option of either applying the rules as proposed, or applying tax treatment that would apply if it were to be liquidated (or partially liquidated where less than 100% of the shares are being sold).

A further possibility, which the writer prefers, is to exclude from these proposals, a sale of shares in a company that has an active business to an unrelated third party. I recommend employee share schemes also be excluded.

It is my view that genuine sale transactions should not be subjected to these rules. If they are subjected to them, the parties will need to price the tax effect. Often, in a share sale transaction a pre-completion dividend is declared and paid to the vendor shareholder in order to make use of imputation credits that would otherwise be lost due to the shareholding continuity requirement no longer being satisfied. The proposals will trigger a tax consequence for the vendor as if such pre-completion dividend is paid, even when it is not. Where no pre-completion dividend is paid, the vendor will suffer the tax consequence as if it is were, without the benefit of cash to support the dividend. The vendor will, accordingly, need to ensure that the share sale price appropriately compensates the vendor for this amount.

6. Movements in Equity

Paragraph 3.19 of the Discussion Document discusses the type of shareholder to which the dividend integrity proposals are to apply. Paragraph 3.22 then discusses the applicable shareholder size and control criteria.

In neither case, does consideration appear to have been given to arrangements that are not share sales but nonetheless have an economic effect of transferring ownership of a company. Examples of such arrangements are:

a) Subscription for shares in a company at an issue price that economically dilutes the interests of existing shareholders.

b) Convertible notes which provide for an issue of shares on maturity at a conversion rate that is at a discount to the prevailing market value of the shares.

c) Options which have an exercise price that is at a discount to the prevailing market value of the underlying shares at the time of exercise.

d) Derivative products, including for example a forward agreement for sale and purchase, that have a similar effect.

I recommend consideration be given to the manner in which these such arrangements will be reflected, if at all, in the proposed rules.

7. Personal Services Income Attribution

Removal of the 80 percent one buyer rule will result in all self-employed persons who operate through a company (usually in order to obtain the benefit of limited liability, and not motivated by tax advantages) becoming subject to section GB 27 unless carved out by the 80 percent one supplier test or the substantial business assets test. Many small businesses will be caught, regardless of any tax purpose. If the 80 percent one buyer test is removed:

(a) The 80 percent one supplier test should remain (and not be reduced) and

(b) The substantial business assets test should not be limited to assets owned by the business. Instead, an appropriate test should establish whether substantial infrastructure is required to operate the business and should factor rentals for leased premises, staff costs, indemnity insurance, software licence costs and other normal business operating costs.

s 9(2)(a)

Peter Speakman
Principal

Telephone: s 9(2)(a)
Mobile:
Email:

From: Sandeep Jain
To: Policy Webmaster
Subject: Submission - Dividend integrity and personal services income attribution
Date: Thursday, 14 April 2022 10:41:24 AM

Hi Team

I have a suggestion that imputation credits in the Imputation Credit Account be limited to 3 years. The company must be forced to distribute dividends to use up imputation credits for closely held companies.

Hope this suggestion will be helpful.

Regards,
Sandeep

From:	s 9(2)(a)
To:	Policy Webmaster
Cc:	s 9(2)(a)
Subject:	Dividend integrity and person services income attribution
Date:	Friday, 22 April 2022 2:33:14 PM

Dear Deputy Commissioner, Policy and Regulatory Stewardship,

I'm submitting in a personal capacity, as a NZ citizen and taxpayer, on your discussion document entitled "Dividend integrity and personal services income attribution". This document was raised to my attention by an editorial, by Brian Fallow, in today's NZ Herald. I found the line of argument in Fallow's editorial to be so tendentious that I have taken the time required to skim through your discussion document. I find myself to be in full agreement your overarching goal of "tax integrity", and with the specific proposals you are making to move toward this goal. Indeed I'd like to thank you for your work to date on this project!

You are welcome to publish this submission.

Best regards,
Clark

Clark Thomborson
s 9(2)(a)

From: Zim Sherman
To: Policy Webmaster
Subject: Dividend integrity and person services income attribution
Date: Sunday, 24 April 2022 4:24:12 PM

Dear respected Ministers and staff,

Please accept this submission. I have omitted comments on sections where I have no strong opinion.

Regarding ASC and ACDA tracking accounts:

Whether the proposal strikes an appropriate balance between compliance costs and tax integrity.

In paragraph 5.2, you say: "Many companies have for their entire existence no more than nominal ASC." As a small business owner, I would say "most companies". At least here in the South Island, most businesses are small family-owned affairs. However, I do recognise this is a problem for some companies, especially the larger ones.

For small business owners like myself, we struggle to keep our overhead low. The expense of a professional bookkeeper or accountant is significant, and, with our relatively simple tax system, largely unnecessary. However, with more and more recordkeeping, the drudgery of business administration expands to fill all available hours, substantially reducing our productivity.

As a compromise, perhaps the recordkeeping should be structured with a threshold, below which no action is required. This would catch the big fish, while not adding to the struggles of the little fish.

Whether the ASC and ACDA memorandum accounts should be reported in annual returns.

Yes, but only if required. Again, a grace-threshold based on income and/or value of assets transferred would prevent small business owners from drowning in a sea of recordkeeping.

Regarding personal services income attribution:

I have strong feeling about this. In paragraph 6.14, you say, "...the economic reality is that the taxpayer is performing work and being paid for it – the entity is effectively just a conduit for the taxpayer’s income-earning activity."

I argue that this is a generalisation, and not true for many small business owners. I will use myself as an example:

My company designs and sells electronics to scientists. It is quite a tiny niche, but every so often, it pays quite well. This pattern leads to some extreme income cycles: in some years we earn $260,000, in other years $7,000. The purpose of the business is to provide some stability. In a good year, I pay myself a standard salary that covers my living expenses; the remainder stays in the company as retained earnings. If I were to instead treat this money as "mine mine mine all mine", then the company would fail instantly when the bad year comes.

• Do you agree with the proposed removal of the "80 percent one buyer" test? Why/why not?

I disagree with the proposed removal.

I understand the need to create a barrier for people who abuse the tax system to avoid paying their fair share. The "80% one buyer rule" guards against people starting a business just so they can avoid being paid as an employee. It is a good rule. If you remove this rule, I would be exposed to quite a large tax burden during the good years. This would severely undermine my financial stability during the bad years.

• Do you agree with the suggested decrease in the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?

I don't think this test is fit for purpose. Some family businesses are legitimate, and others are tax shelters. Whether it's one person or two doesn't change this.

It seems the original legal structure was created to catch a specific type of person -- a sole proprietor with a large income derived from (mostly) a single customer, for work that does not require a lot of investment. Essentially, this describes consultants who cater to one customer.

What about the electrician who has an apprentice riding with her? 80% seems in the spirit of the original law, but at 50% you start to catch people you hadn't intended to catch.

• Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?

A business can still be legitimate if it does not require expensive equipment. I get paid for abilities that I have acquired over decades, but the tasks that I perform require very little equipment. What are my assets? Who can measure them?

• Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter?

I think there are better ways to test whether the owner is truly invested in the business, besides summing the dollar value of the tangible assets.

It is sometimes hard to say whether the earnings should be taxed as personal income, but if earnings are retained in the company -- and doesn't distribute the earnings through a trust, etc. -- those earnings are invested in the health of the company. That indicates that the owner treats the business as more than the conduit you describe in paragraph 6.14.

• Do you consider the net income threshold should be increased from $70,000 per year to $180,000?

I think it could be increased, but a 157% bump seems like a lot. $110,000 ($60 per hour) is a reasonable figure for most professionals. To be honest, I think the value is irrelevant. The question is whether those earnings are personal or business in nature.

I understand your dilemma. It is important to test whether a business is legitimate, or just a way to hide personal income from the taxman. However, this proposal burdens legitimate small businesses.

Two take-home points:

- Because every business is different, you can't paint them all with the same brush. Business owners know their circumstances better than you do. Allow business owners to regulate their own personal income, and allow their businesses to retain earnings for a rainy day.
- Put pressure on the business owners who are transferring wealth out of their company inappropriately, but please find a better way to do it. (Target the inappropriate wealth transfer, not the legitimate earnings of the business entity.)

Sincerely yours,

Zim Sherman
Scienterra Limited
Oamaru, New Zealand
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CAREY ADVISORY LIMITED
s 9(2)(a)

www.careyadvisory.co.nz

25 April 2022

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

Via email : policy.webmaster@ird.govt.nz

Submission – Dividend integrity and personal services income attribution

I refer to the Government discussion document on dividend integrity and personal services income attribution ("Document"), and as invited, I make a general comment and then provide specific comments and submissions on the personal services income attribution proposals discussed in the Document.

General
In the Introduction, the Document fairly raises a number of valid issues and fairly discusses certain of the consequences of lack of alignment in income tax rates amongst individuals and trusts and companies, and also references this discussion to the background position of New Zealand not having a broad based capital gains tax.

I would submit the lack of alignment in income tax rates, which is driven by political concerns of the current Government, is the key driver of the issues discussed, and it is important to acknowledge this fact.

New Zealand like all developed countries has long established law and practice around companies, trusts and other similar entities, and there are many valid societal, commercial and family reasons for the use of such entities. Accordingly for very good reasons, mostly unrelated to tax outcomes, the use of such entities is long embedded in New Zealand.

I would submit the Document is flawed in its logic of attributing many of the issues discussed to the valid use of such entities, which have all been in existence and use for decades before the tax policy of the current Government.

The current Government needs to be honest and logical, and needs to accept the consequences of differential income tax rates, and with them, the facts that significant unnecessary complexity will be added, and tax integrity will be reduced, if the Government, somewhat arbitrarily, determines the differential tax rates are applicable in some situations and not in others – which is effectively what the proposals in the Document will give rise to, (other than those proposals which relate to recording ASC and ACDA, which do seem inherently sensible).

Submissions on personal services income attribution

The personal services income attribution rules have always been primarily aimed at "pseudo-employees". The underlying logic was effectively to ensure that if a person entered a long term contractual arrangement with another entity for the supply of personal services, which would generally be an employment arrangement, and if the person and the entity structured the arrangement as that of independent contractor with an inter-posed company, the tax legislation would effectively recharacterise the related income stream as employment income.

In addition a few additional factors were added to the applicable definitions to ensure that a relevant person/company, in a quasi-employee situation, who were not truly in business, could not easily structure their affairs in these sorts of situations to fall outside the proposed ambit of the personal services income attribution rules.

It was never intended that the personal services income attribution rules should apply to a situation where the person/company were truly in business, and as such subject to the risks and rewards of business. In particular there was no logic, and there remains no logic, for treating one business differently from another business, from an income tax perspective, simply because one business is small and the other business is not.

With this background in view I comment upon and submit on the proposed changes as follows:

- The key issue to determine for application of the personal services income attribution rules should always be whether the person/company is a quasi-employee?
- In determining this issue, one can safely and logically rely on the premise that a person/company is not a quasi-employee if the person/company carries on a business, with the attendant risks and rewards of business, as practically and legally it is well accepted that the status of carrying on a business is well different from the status of being in employment.
- The current approach (and tests/thresholds) applied in the personal services income attribution rules focus on factors which are mostly relevant to determining whether the person/company carries on a business, having regard to the above premise that a person/company will not be a quasi-employee if it carries on a business.
- Noting the above approach in the current personal services income attribution rules, logically the proposed changes should only be pursued if they assist to better resolve, in today's economic environment, the issue as to whether a person/company is truly in business, and with it subject to the risks and rewards of business.
- It is long established best practice in New Zealand, and all other comparable jurisdictions, to operate a business through a company format. Reasons include: limited liability, risk, separate legal personality, commercial perception etc.
- A business, no matter its size, should be able to, and indeed should be encouraged to, follow best practice. Why should a large business be able to operate, in accordance with best practice, as a company and with company tax consequences, yet a smaller business would not be able to both operate as a company and have company tax consequences?

- The proposed changes with respect to thresholds for buyers and natural person suppliers seem completely arbitrary and do not assist with the issue as to whether the person/company is in business.
- In particular, the logic behind examples 8 & 9 seems entirely flawed. Surely if a company is conducting a business with a number of customers, the company, is not a quasi-employee, is in business, and should be taxed as such.
- Given the company in the example has a number of customers, there would be no doubt that the company would be a business if it had many service suppliers. Why should this result alter if it does not have many suppliers? There are any number of reasons why that company is in business and has a single supplier (choice, business size, flexibility, constrained by investment funds available, constrained by customers available etc). The fact that the company is in business would remain, large or small.
- New Zealand has many small businesses following best practice and operating as companies, and providing a range of services.
- The size of the business, and the number of buyers and natural person suppliers, (beyond certain obvious business-related thresholds, (such as those currently applicable)), are completely irrelevant as to the inquiry of whether the company is carrying on a business and should be taxed accordingly.
- **If the proposals in this area are pursued, small businesses in a number of situations, many completely arbitrary, would be taxed in a quite different way from larger businesses. Such an outcome arbitrarily penalises smaller businesses and clearly lacks integrity.**
- With the above comments in view I submit the current thresholds for buyers and natural person suppliers should not be changed.
- The suggested changes to the substantial business asset tests do not seem to be based on useful logic, and do not seem to assist to answer the relevant questions. Most businesses in the personal services areas in today's world are heavily reliant on information technology, (with or without the need for other specific business related assets), and the cost of computers and software etc has not risen to such a level as to make the suggested optional levels of $150,000 or $200,000 realistic. Hence I submit the substantial business assets threshold should not be increased as proposed. If anything, the substantial business assets threshold should be reduced. (For example, how many quasi-employees do you know who currently have $75,000 or more of business assets?).
- Given the reasons the Document advances for looking at this area, and given the breadth of the deemed dividend rules, I see little logic in keeping the income threshold at $70,000.
    - There should be no impediment to retaining income (by way of retained earnings) in a company for ongoing business funding purposes. This approach is common to all companies, and small companies should not be restrained or penalised in this regard.
    - Alternatively if the income is not required for business funding purposes, and is somehow to be advanced or made available to the working person, one would very reasonably expect that the broad deemed dividend rules would apply to the amount advanced or made available, and would tax the associated benefit as a dividend at appropriate tax rates.
- Therefore retaining the $70,000 income threshold is entirely unnecessary in the context of the broad deemed dividend rules, and would seem only to add

unnecessary compliance costs, and accordingly I would submit the income threshold should be raised to $180,000.

Summary Submission

Based on the detailed comments/submissions above, I submit that none of the proposed changes to the personal services income attribution rules in the Document should be adopted.

As noted at the outset, the issues the Document perceives are largely consequences of the current Government's policies on differential tax rates. Should the current Government find these consequences undesirable, it should not seek to alter these consequences with proposals that produce arbitrary and unfair results, particularly for small businesses, given the preponderance of small businesses in New Zealand.

Whilst I am not advocating this approach, I would observe that a more sensible approach to deal with the consequences that the current Government finds undesirable with its differential income tax rates may be to implement law/binding guidance around minimum market based levels of remuneration for working persons. I do not favour such an approach as it increases compliance costs, however at least it would be fair and would not arbitrarily penalise small businesses.

Yours sincerely
CAREY ADVISORY LIMITED
s 9(2)(a)
[redacted]

Richard Carey [redacted]
Director

From:	Les Harvey
To:	Policy Webmaster
Subject:	Dividend integrity and person services income attribution
Date:	Monday, 25 April 2022 4:56:31 PM

Hello,

- I do not agree with the proposed removal of the 80% one natural person supplier test.

  The issue is that salaries to those that perform the services are alleged to be less than market so are under-taxed. Removing this test would result in all net income being taxed as personal services income rather than just the component attributable to "employee-like" services, with none being recognised as business income attributable to the business risks being borne, such as irregularity of income and lack of protection and benefits under the employment laws. A proposed remedy is that salaries to those who perform the services should be required to be at least market salaries, with the onus on the company to show the salaries are at market.

- I do not agree with the proposed removal of the 80% one buyer test.

  Again, the issue is that salaries to those that perform the services are alleged to be less than market so are under-taxed. Removing this test would result in all net income being taxed as personal services income rather than just the component attributable to "employee-like" services, with none being recognised as business income attributable to the business risks being borne, such as irregularity of income and lack of protection and benefits under the employment laws. A proposed remedy is that salaries to those who perform the services should be required to be at least market

You are welcome to contact me if you wish to discuss this submission

Kind regards,

Les Harvey
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26 April 2022

Policy and Regulatory Stewardship
Inland Revenue Department

By email: policy.webmaster@ird.govt.nz

Re: Dividend integrity and personal services income attribution – Government discussion document

1. The New Zealand Law Society | Te Kāhui Ture o Aotearoa welcomes the opportunity to comment on the Government Discussion Document *Dividend integrity and personal services attribution* (the **Discussion Document**).

2. These comments respond to the questions as set out in the Discussion Document. They have been prepared with the assistance of the Law Society's Tax Law Committee.

Part I: Shares

3. Overall, the Law Society does not support the proposals outlined in Part 1 of the Discussion Document. The proposal is, in substance, a capital gains tax – it recharacterises the sale proceeds of shares held on capital account as a taxable dividend. This is inconsistent with the Government's publicly-stated policy to not tax capital gains.

4. The proposal fails to recognise that a key distinction between what is a legitimate capital transaction with a third party, and a dividend stripping structure, is the lack of a motivation to strip out a dividend from the company. Sales of shares to third parties occur due to the decision by the shareholder to dispose of its capital investment. Therefore, this is not a dividend integrity issue.

5. The Law Society is of the view that it is not appropriate indirectly to enact a capital gains tax in this manner, whether intended or not, when it is known that such an effect would be contrary to stated government policy on capital gains tax. Further, describing the proposals as 'dividend integrity measures' may have inadvertently undermined consultation on what are significant proposals, the consequences of which may not have been appreciated by potential submitters.

6. There are other, significant, issues not considered in the Discussion Document that are essential to the design of the proposal and which should be consulted on. For example, the proposal, as described, would be retrospective as it would apply to the retained earnings of a company since the company was incorporated. Further, there is no consideration of any grandparenting, the effect on sale of shares on death, or the impact this proposal will have on domestic investment and productivity.

<u>Questions</u>

<u>Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?</u>

7. The Law Society does not agree that this is an appropriate policy outcome, and considers the proposal should not proceed, because:

   a. There are genuine commercial reasons for companies not distributing amounts to shareholders. These can include the need to reinvest retained earnings, to drive capital growth (i.e., payments expended on expanding the taxpayer's business, or the growth of a capital asset).

   b. Paragraph 2.23 of the Discussion Document implies that the increased balances of non-listed companies' imputation accounts are attributable to businesses deciding not to incur the tax which would arise from distributions, and instead looking to sell a company and access a tax-free capital gain.

      i. We consider this is incorrect. Whether a company pays a dividend and whether shareholders decide to sell their shares in a company is determined by a range of commercial factors, often outside of the control of the company or the shareholders. For example, changes in the investment market away from income generating assets towards capital growth stock.

      ii. A clear example of this is New Zealand's tech sector, which will generally not pay dividends to its shareholders, instead making the business decision to reinvest profits, to develop world leading technologies. If instead such companies are concerned with the tax bills that may arise when, say, a venture capitalist or angel investor makes an investment, they may be more inclined to distribute dividends regularly to avoid a lump sum tax charge.

   c. The experience of practitioners is that the purchaser in a transaction will often require the target to declare a taxable dividend immediately prior to the transaction, equivalent to the total amount of cash held by the company. This is commonly achieved by an agreed working capital statement in the sale and purchase agreement. Contrary to the Discussion Document's underlying premise, a vendor does not sell a cashed-up target to a third-party purchaser. This is because the purchaser of the shares does not want to pay 'cash for cash'.

   d. The proposed rule would in effect create a 'shadow' capital gains tax on shares otherwise genuinely held on a capital account that would not ordinarily be taxable. Imposing a tax on the sale of shares to third parties would create a financial penalty for entering a transaction and could prevent commercially beneficial transactions from taking place. This would be an example of tax policy unduly impacting commercial outcomes.

   e. The proposed rule is unnecessarily complex, and seeks to target a perceived risk that is not borne out in practice:

      i. It is not the experience of practitioners that taxpayers dispose of their share interests in order to access untaxed gains. Ordinarily, taxpayers dispose of their interests when they consider they can realise value on a capital asset that aligns with their investment horizon, or with a need to introduce new shareholders to the company, and not because there is a large sum of retained earnings on the balance sheet. There are existing avoidance rules in force to counter this issue, and the Commissioner is known to be actively considering transactions of interest, as an operational matter.

ii. Moreover, the current proposal does not consider the many complexities associated with introducing what is, in effect, a form of capital gains tax – including:

- Whether any rollover relief would be available (i.e., upon the death of shareholder) and, in the event that no relief is allowed, whether the proposal would act as a form of inheritance tax on shares owned by relatives.
- The application of the proposal in the event of an internal reorganisation.
- The application of the proposal to employee share schemes.
- The conflict between the current proposal and existing regimes in the Income Tax Act. For example, the ability of New Zealand companies to receive as exempt income dividends from CFCs engaged in active business.
- How pre-enactment retained earning would be treated. Specifically, whether there would be a valuation date or whether the retained earnings of a business would be 'grandparented.'

8. In addition, the proposal will apply inconsistently to only New Zealand tax resident persons, as it is not currently proposed to apply to businesses owned by non-resident shareholders. This proposal may disincentivise local investments in New Zealand businesses by increasing the cost of investment, which has the potential to reduce productivity generally (particularly when coupled with the current tax rate for inbound investment).

9. Should the proposal proceed, the Law Society is of the view that this proposal should only apply to future acquisitions, for which taxpayers are aware that the capital gain of their shares would be taxed (and so the relevant return on investment can be accurately calculated). The proposal is retrospective as it taxes retained earnings arising prior to enactment and will impact the return on investments already made. Taxpayers have acquired shares on a capital basis expecting that the capital nature of the asset would be respected, especially so considering the Government's policy not to tax capital gains.

Should the scope of the proposed recharacterisation rule cover all of scenarios A, B, and C?

10. For the reasons outlined above, the Law Society does not consider that the rule should be introduced for any of the scenarios outlined in the Discussion Document.

11. Scenario A is covered by existing law. The Law Society considers that the tax legal landscape is already saturated. Adding a new rule that will overlap considerably with existing law is not desirable.

12. Scenarios B and C relate to arms' length transactions between parties that are not associated. These rules would add a level of complexity that would make business transactions unnecessarily more difficult to complete, could lead to a loss of business activity, the adoption of new business structures or tax-driven changes in business investment strategies.

Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?

13. The Law Society considers the proposed rules are too broad. Imposing a tax only on controlling shareholders seems to be somewhat arbitrary, and could create inequitable outcomes, as illustrated in the below examples:

    a. A business set up by two unrelated individuals, owning 51% and 49% respectively. The shareholding is based on the amount that was genuinely available by both parties to be invested into the business. Clearly in this case, there is an advantage gained by the 49% shareholder, because when they have reached their investment horizon and seek to realise a return on their capital asset, they will not be subject to the proposed rule. However, the 51% shareholder would be, and would likely receive lower capital return compared to the other shareholder despite owning a larger percentage of the company.

    b. A New Zealand investor which acquires more than 50% of the shares in a company, which had not previously had any one person (or group of related persons) with an interest of more than 50% (i.e., these proposed rules would not apply to the vendors, and there would be no step up in ASC etc). The company has been operating for the best part of 15 years, and has not paid a single dividend as all profits have been reinvested into the company's business. The investor holds the shares for 5 years, and no dividends are paid in this time. When the investor seeks to dispose of the asset, they will be taxed on 20 years of retained earnings, of which they were not a shareholder for 75% of the time.

       The Discussion Document does not contemplate whether the retained earnings created prior to the enactment of the proposal would be taxed in a scenario such as the above. Further, it does not contemplate whether retained earnings arising prior to the controlling shareholder obtaining a shareholding would be subject to this proposal.

14. In addition, the proposed application of the associate and 'act together' rules are too broad. If an 'act together' test like the definition in the hybrid rules is adopted, then the breadth of the proposal will be very wide, and likely beyond the scope of the intended objective of counteracting tax avoidance.

15. If the rules are to proceed, the Law Society considers a more appropriate threshold would be for application of the rules to those with more than 80 percent of the voting interests in the company.

Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?

16. As outlined, the Law Society does not agree with the proposed rules in principle.

What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two) and which of these approaches do you prefer? Is there an alternative approach you would suggest?

17. If the proposal is adopted, the Law Society suggests that the most appropriate quantification approach would be to calculate the deemed dividend on the lower of the grossed-up ICA balance and the sales price, for the following reasons.

18. We do not consider that retained earnings should be used to quantify the deemed dividend. Retained earnings is an accounting concept, and its computation is clearly governed by a set of accounting standards (i.e., GAAP or IFRS) and not taxable profits. There are a range of items that go into the computation of retained earnings that may not otherwise give rise to income

tax. For example, profit could include significant unrealised gains (e.g., property) that would not be taxed, which is clearly the case as there are adjustments made in tax calculations.

19. Another example is a profit in one accounting year which will be reversed in subsequent years (for example, a mark to market gain on a long-term supply contract). To then tax these amounts via the proposed rules could result in over taxation, and again encourage regular distribution of dividends which otherwise would have been reinvested into the business. Further, the flexibility of accounting rules and their inconsistent application could cause a range of issues. Recourse to tax concepts is desirable to ensure that the scope of this rule is not broadened due to changes in accounting standards.

20. ICA accounts will not always be reflective of undistributed earnings in a company. For example, deposits / withdrawals can be made from tax pools that would increase or decrease the ICA of a company. In addition, an ICA is predominantly impacted through provisional tax. Provisional tax, by its very nature a 'guesstimate.'[1] Ordinarily, provisional tax is overestimated to avoid UOMI and penalties. This could result in a shareholder paying more tax than would otherwise have been paid if regular dividends had been paid – again, this could encourage regular distributions of dividends and is not conducive to good business practice. Despite these drawbacks, if the proposal is to be adopted, we consider the grossed-up ICA balance to be the better of two difficult options.

21. To the extent these rules are implemented, it will be important any deemed dividend that would arise is capped at the cash proceeds, not the total sale proceeds, as this could result in a "dry" tax charge for the vendor.[2]

<u>Do you agree with the proposed approach (outlined in Example 3) for calculating dividends and ASC adjustments for corporate groups?</u>

22. Example 6[3] demonstrates the complexity of this proposal. Further, it only calculates the retained earnings based on the grossed-up ICA balance and does not demonstrate how the accounting retained earnings would be calculated. Therefore, we consider that the proposed approach outlined in Example 6 does not adequately explain the full impact of this proposal.

23. As noted above, and as noted in the Discussion Document, the ICA balance is not a perfect measure, and could result in over-taxation.

<u>Is the approach outlines in Example 4 for a sale of one controlled company to another (existing) controlled company (potentially generating a deemed dividend from both companies) correct conceptually?</u>

24. The Law Society notes that applying such a rule to activities within a corporate group will likely impact normal corporate activities, such as corporate restructures, outside of the policy intent of this initiative.

Part II: ASC and ACDA tracking accounts

<u>Whether the proposed transitional rule is appropriate</u>

25. Given Inland Revenue's views on current law applying to ASC (and by extension, ACDA), the Law Society does not consider there is a compelling case for further administrative reporting.

26. However, should Option 1 be adopted, the transitional rule appears to be appropriate. We consider that ASC should be debited on a FIFO basis, such that is should be debited against FSC

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[1] This is somewhat accepted at paragraph 3.33 of the Discussion Document.

[2] As noted at paragraph 3.41 of the Discussion Document.

[3] This appears to be the intended reference.

prior to the formation of a tracking account, with any residual ASC not used then only being added to a tracking account. This method means taxpayers would have to calculate historical ASC amounts only when they seek to return an amount of ASC, and not immediately.

Whether the Commissioner should be able to reopen a return and on what basis

27. Consistent with other provisions across tax legislation, it would seem inappropriate for the Commissioner to reopen a return. The time bar should apply.

Whether the proposal strikes an appropriate balance between compliance costs and tax integrity

28. The Law Society is of the view that this proposal creates unnecessary compliance costs.

29. As noted in the Discussion Document and in OS 22/01,[4] taxpayers already bear the onus to evidentially substantiate the ASC and ACDA amounts of a business. Imposing an administrative barrier that would bar a proper claim of an ASC amount under Option 1, even where there is the evidence to prove such ASC amount, is undesirable. Further, the Law Society does not see any difference in substance between Option 2 and the current law. Option 2 is voluntary, just as the current law (as reflected in OS 22/01) is, in that a company can decide whether or not to keep records in relation to ASC (and ACDA) which would allow it to substantiate a claim in the future.

Whether the ASC and ACDA memorandum accounts should be reported in annual returns

30. We do not consider this should be required. The law currently imposes an evidential burden on taxpayers to prove they have the claimed ASC or ACDA. This would impose a further compliance burden.

Part III: Personal services income attribution

Do you agree with the proposed removal of the '80 percent one buyer' test? Why/Why not?

31. This appears to be appropriate.

Do you agree with the suggested decrease in the threshold for the '80 percent one natural person supplier' test, from 80 percent to 50 percent? Why/Why not? Can you foresee any problems arising from the suggested change?

32. The Law Society does not agree with this proposal, as it may have unintended consequences.

33. For example, consider a business with one principal and two others (a junior and a manager). To the extent the principal's charge out rate is higher than the others, they may derive 50% of the revenue for the firm. However, in this instance, there would be genuine reasons for a corporation to be used, namely, to be an employer for the other two staff members. To say the principal in this case is using a corporation to avoid tax in such a situation is incorrect. Further, this would add considerable complexity to the taxation of small businesses (or non-compliance for those who are not aware of such a rule).

Are the suggested thresholds for the substantial business assets test appropriate? Why/Why not?

34. They appear to be appropriate, particularly considering rising costs due to inflation.

35. The Law Society does not agree there is a need to remove the cost of vehicles. In particular, the reference to luxury vehicles – it is not clear what the definition of this is. A luxury vehicle is

4 Available Subscribed Capital record keeping requirements.

subjective and would be difficult to define. In most cases, FBT should be returned on such vehicles if it is not otherwise exempted. It is not clear why these costs should be excluded.

Which of options one and two do you consider to be preferable? Is there another option that you think would be better then either of the thresholds suggested in this chapter?

36. Option 2 is preferred, as smaller legitimate businesses do not tend to have very large capital assets.

Do you consider the net income threshold should be increased from $70,000 per year to $180,000?

37. The Law Society considers the rule should be focused on those who are deliberately structuring to avoid the top marginal tax rate – being those who would otherwise be subject to the 39% tax rate, that are earning $180,000 and over.

38. Moreover, this would more likely capture those who are using a trust to hold the relevant company (i.e., those who seek to gain the tax advantage between the 33% trust tax rate and the 39% top marginal tax rate).

Further feedback

39. Thank you again for the opportunity to provide feedback on the Discussion Document. If you have any questions or wish to discuss the Law Society's feedback, please contact s 9(2)(a).

Nāku noa, nā

s 9(2)(a)

Frazer Barton
Vice President

From: Neil McGarvey
To: Policy Webmaster
Subject: Dividend integrity and person services income attribution - submission
Date: Tuesday, 26 April 2022 2:32:52 PM

Questions for submitters

- Do you agree with the proposed removal of the "80 percent one buyer" test? Why/why not? Yes. An employee at a large firm usually does work for more then one main client, yet gets taxed at the highest applicable rate. Self employed should be treated in a similar fashion.
- Do you agree with the suggested decrease in the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change? I support this - but wonder what proportion of consultants are 1 person only so do 100% of the work and this wouldn't affect them. Also would it discourage employing others to grow a business?
- Are the suggested thresholds for the substantial business assets test appropriate? Why/why not? Not sure, no business experience
- Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter? Not sure, no business experience
- Do you consider the net income threshold should be increased from $70,000 per year to $180,000? No. I would like equitable treatment of all taxpayers so the threshold should be the same at $70k

Dear IRD,

Overall I support the suggested changes to tax rules proposed in the discussion paper because:

1. As a salaried employee myself, I know that employees are sitting ducks for PAYE and have no recourse to reduce tax by any of the mechanisms in the discussion paper. Private citizens contribute a large proportion of tax revenue through being employees, aka "wage slaves".
2. There is an increasing trend towards what is known as the "gig economy", which for many individuals means forming their own small company with only themselves or perhaps one other and essentially becoming consultants instead of employees, often providing services to only 1 - 3 main clients, and minimising their tax bill by the mechanisms in the discussion paper.
3. These two trends lead to an unbalanced situation where salaried employees are unfairly contributing a larger share of the tax revenue, and the number of employees is reducing as some create their own companies to become consultants in order to minimise their tax obligations. For the sake of equity I support the changes in this discussion paper.

Kind Regards,

Neil McGarvey

NZGIF / NEW ZEALAND GREEN INVESTMENT FINANCE

27 April 2022

Email: policy.webmaster@ird.govt.nz

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

Dividend Integrity Proposal – NZGIF Submission

Thank you for the opportunity to submit on the Government's review of the dividend integrity regime.

New Zealand Green Investment Finance Limited was established with the purpose of accelerating and facilitating low emissions investment and is a company listed in Schedule 4A of the Public Finance Act.

We have a broad investment mandate and have the flexibility to use several different structures (including owning equity in businesses) to make investments that can further our objectives.[1] We currently have four equity investments and regularly consider others.

We were incorporated for the purpose of investing to reduce emissions, and to help others to do the same. As an entity owned and funded by the Crown, we certainly support a tax system that has integrity, and has rules that are not easily circumvented. As is already the case, the Crown will need to invest heavily in climate change mitigation and adaptation over the coming years; having a tax system under which people contribute their fair share will be important to that investment.

However, anything that makes it harder to provide finance to reduce Aotearoa New Zealand's emissions will make the job of mitigating climate change significantly harder. Climate change presents a fundamental threat to our way of life and the solution to it will involve innovative businesses developing new processes, products, technologies, and services. Many of the businesses that will be at the forefront of the required change are in their infancy now. Businesses we see that are developing these new processes, products, technologies, and services are often small, closely-held companies, run by founders with a passion for their business. Those businesses need to be able to grow, and their founders need to see a path to reward for the effort the put in and the risks they take.

While we support the general principle in the dividend integrity proposal that shareholders should pay tax at their marginal rate on income from a company they control (where that income is subject to a dividend stripping arrangement), we submit that thought needs to be given to the circumstances in which a shareholder should be considered to be dividend stripping.

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[1] Our objectives are: to invest to reduce emissions; to crowd-in private capital; to invest on a commercial basis; and to show market leadership.

Scenario A described in chapter 3 of the discussion document is clearly a circumstance in which a deemed dividend is appropriate. Where a shareholder retains the same economic interest in a business but structures a transaction to avoid a taxable distribution, the shareholder should pay the tax they sought to avoid.

Our concern is that Scenario B (and, by extension, Scenario C) could lead to potential unintended consequences.

Our principal concern is that the proposal could lead to a misalignment between shareholders in companies that are majority owned by a founder, but which have received investment from third parties to fund capital expansion. If the founder is likely to receive a large tax bill on exit, the price at which they are willing to transact will likely increase. This might result in the founder setting unrealistic expectations for the value of the business. That, in turn, could lead to reduced interest from potential purchasers. Founders who are opposed to an exit when the appropriate time comes will present challenges for growth investors like us.

Even if founders and minority shareholders are on the same page regarding valuation, our secondary concern is that exit transactions will be over-engineered to avoid tax implications. For example, we are aware that transactions in the US are often completed at a lower headline sale figure to reduce capital gains tax, but have complicated earn-out structures for sellers designed to reflect the 'true' value of the business to the seller and purchaser. Overly complex transactions would be a boon to legal and tax advisers, but that is a sub-optimal outcome in circumstances where the mischief sought to be avoided is unlikely to be present.

The discussion document refers principally to the concern of company structures being used to avoid the top marginal rate of personal income tax. In our view, this is much more likely to happen when a business owner is able to finance their lifestyle through their business. Where a business has the added discipline of independent shareholders, the likelihood of this is much lower as those shareholders are likely to include use of proceeds clauses in their capital subscription documents and will exercise a degree of budgetary control. For example, we would not allow any founder of a business that we invested in to finance their personal expenses through that business.

As such, we submit that the dividend integrity regime should be disapplied where there are material independent shareholders in a business, even if that business is ultimately majority owned by a controlling individual.

We would welcome the opportunity to discuss this submission in more detail.

Nāku, nā
New Zealand Green Investment Finance Limited
s 9(2)(a)

Ian MacKenzie
Head of Legal

27 April 2022

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

By email: policy.webmaster@ird.govt.nz

Submission on dividend integrity and personal services income attribution

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About the Submitter

1. This submission has been prepared for the *New Zealand Taxpayers' Union* by OliverShaw, a specialist tax advisory practice founded in 2011 by Robin Oliver MNZM LLB MA and Mike Shaw CA.

2. Founded by David Farrar and Jordan Williams in 2013, the *Taxpayers' Union's* mission is Lower Taxes, Less Waste, More Transparency. We enjoy the support of some 170,000 registered members and supporters, making us the most popular campaign group championing fiscal conservatism and transparency. We are funded by our thousands of donors and approximately five percent of our income is from membership dues and donations from private industry supporters.

3. We are a lobby group not a think tank. Our grassroots advocacy model is based on international taxpayer-group counterparts, particularly in the United Kingdom and Canada, and similar to campaign organisations on the left, such as Australia's Get Up, New Zealand's ActionStation, and Greenpeace.

4. The *Union* is a member of the World Taxpayers Associations - a coalition of taxpayer advocacy groups representing millions of taxpayers across more than 60 countries.

5. We give permission for Inland Revenue to publish this submission.

Introduction

6. The government discussion document ("the Document") proposes three changes. This submission is on two of the proposals:

    a. Shareholders being taxed on the sale of shares in a company to the extent that the company (and its subsidiaries) has retained earnings

    b. The changes to the personal services company rules that effectively remove when small business can use the lower corporate tax rate.

7. We strongly oppose both these proposals as in effect, they amount to additional taxes on small businesses. The case for such ad hoc measures being necessary to buttress the 39% income tax rate is not made in the Document.

8. Instead, these measures would prevent small businesses from using retained earnings taxed at the corporate tax to invest in the firm's plant and machinery and other necessary business assets.

9. Taxing share sales on the gross value of the underlying retained earnings, in effect, deems all such earnings to be distributed to the vendor shareholder at the time of the share sale. However, the earnings are still invested in the firm funding business assets. There is no justification for deeming this to be income of the vendor shareholder when it is still invested in the business.

10. Applying this rule to all controlling shareholders including shareholders who "act together" would mean the rule would apply to most family businesses. In effect they are then denied the 28% company tax rate for reinvested profits that other larger businesses have.

11. The current personal services attribution rule deems the income of a company that is in effect merely the single shareholder's employment income to be income of that shareholder and so is taxed at individual rates not the company rate. For the rule to apply currently:

    a. <u>80%</u> of the firm income must come from <u>one client</u>; and

b. The owner must generate 80% or more of the firm profits; and

c. The firm must have less than $75,000 in business assets.

12. The proposal is in effect to apply this rule to many family businesses that have fewer than two or three employees and business assets less than $150,000 to $250,000. This would cover many tradies and small contactors. They would be denied the ability to finance assets out of profits taxed at the 28% company tax rate. We say that is unfair and wrong.

Taxation of the sale of shares

13. The Government proposes that when a shareholder sells their shares, they will be taxed as a dividend on a portion of the shares if:

    a. they are a controlling shareholder owning more than 50% of the shares; or

    b. if they are "acting together" with other shareholders where they and the other shareholder control the company.

14. The taxable dividend will be the greater of:

    a. the shareholder interest in the retained earnings of the company (grossed up for imputation credits); or

    b. the quantum of imputation credits in the company (grossed up by the tax rate).

15. Our opposition with taxing the sale of shares is as follows:

    a. The stated problem is avoidance of the 39% tax rate. The proposals are not limited to such avoidance. (See: Problem definition)

    b. The proposal is, in many cases, a tax on the gross return from the sale of shares and therefore in some cases it will be on an amount that exceeds the economic income of the shareholder. (See: Taxation on gross proceeds)

    c. The proposals are not practical and therefore not workable. (See: Proposals are not practical)

    d. The practical effect of the proposals will materially impact on commercial transactions and in some cases result in commercial transactions now not occurring. (See: Economic distortion caused by the proposals)

Problem definition

16. The Document outlines how the Government is concerned about the integrity of the 39% tax rate for individuals.

    a. "The Government's <u>work on integrity measures to support the 39% personal income tax rate is being progressed</u> in tranches. Tranche one, which is the focus of this discussion document, concerns dividend integrity and income attribution measures" (page 5)

b. "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)". (Para 1.7)

c. While the Government's main concern is the integrity of the 39% tax rate, the proposals in this document can affect taxpayers at any personal tax rate in situations where some of or all their income is being earned through entities. (para 1.9)

17. The proposed solution is considerably wider than the problem as outlined above. While reference is also made to avoidance at the 33% tax rate, again the proposal is not limited to avoidance of these rates. As outlined below, the proposal is a tax on gross income and is unrelated to taxpayers who are on the 33% or 39% tax rates. For example, a widely held corporate which has no controlling shareholder is subject to these rules while its tax rate is 28%. Further all its shareholders might be portfolio investment entities, again this is of no relevance to the stated problem definition.

18. As detailed further below, the proposal is a tax on the gross proceeds and not on the net gain of the shareholder. Taxing a shareholder on their gross sales proceeds has no relationship to their actual gain. For example, it is possible under the proposal that a shareholder sells shares at a loss however, under the proposal, they have taxable income. Again, this is not related to the avoidance of the 39% tax rate.

19. It is proposed that the measure not apply to the sale of shares in a listed company and the sale by non-controlling shareholders (unless they are acting together with other shareholders who control the company). If this is the right policy outcome for major shareholders, then it would seem logical it should apply to all shareholders. The document says it is not practical for non-controlling shareholders to undertake the detailed calculations, however as discussed below, we do not believe it is practical for controlling shareholders.

Taxation on gross proceeds

20. The proposal is to tax the shareholders interest on the greater of:

a. The retained earnings of the company

b. The grossing up of the imputation credits of the company

21. This is a tax on the gross proceeds and not on the net gain of the shareholder. It is clear from the Document that this the intended outcome. (Para 3.41)

22. This would result in absurd outcomes. For example, where the controlling shareholder acquired a company that already had retained earnings and subsequently sells those shares, the shareholder will be taxed both on retained earnings accumulated during the ownership of the shareholder *and* the retained earnings in the company when it was acquired by the shareholder (pre acquisition retained earnings). That amounts to double taxation.

23. Not only would this mean that a person is taxed on retained earnings derived before they had an interest in the company, but they are also taxed if the shareholder sells the shares at a loss.

a. In table format we provide the following examples where a company is acquired and then disposed of. In all the examples below, the gain (loss) on the sale shares is unrelated to the tax liability incurred by the shareholder:

Balance sheet at acquisition	example1	example2	example3	example4
Net assets of company	**130,000**	**130,000**	**130,000**	**130,000**
Shareholders equity				
Paid in capital	10,000	10,000	10,000	10,000
Capital gains	20,000	20,000	20,000	20,000
Retained earnings	100,000	100,000	100,000	100,000
Total shareholders equity/net assets	**130,000**	**130,000**	**130,000**	**130,000**
Cost to acquire the shares	**130,000**	**130,000**	**130,000**	**130,000**

Balance sheet at sale date				
Net assets	**130,000**	**80,000**	**180,000**	**110,000**
Shareholders equity				
Paid in capital	10,000	10,000	10,000	10,000
Capital gains	20,000	20,000	20,000	-
Retained earnings	100,000	50,000	150,000	100,000
Total shareholders equity/net assets	**130,000**	**80,000**	**180,000**	**110,000**
Sales value of shares	**130,000**	**80,000**	**180,000**	**110,000**
Gain over costs	**-**	**- 50,000**	**50,000**	**- 20,000**
Taxable income under proposals	100,000	50,000	150,000	100,000

24. The above examples are where a company is acquired and then sold. Unwarranted tax liabilities can arise when a company was incorporated by the shareholder and then disposed of. As noted para 3.41 of the Document states this is the intended outcome. An example of this is as follows:

Profits	138,889
Less tax at 28%	38,889
Profits after tax	100,000
Capital loss	- 50,000
Shareholder's funds/net assets	**50,000**
Sale value	50,000
Gain on sale of shares	50,000
Taxable income	100,000

25. Paragraph 3.41 states that if the loss was allowed this would effectively allow a deduction for capital losses. The problem with the above, is that it is taxing gains that never eventuated. Further, if the company was first liquidated and the shareholder then sold the net assets of the company for $50,000 then the tax that arises under the proposals would not arise. This is an absurd result. No tax liability would arise if instead of selling the company it is liquidated and then the distributed assets sold. The alternative of liquidating the company will obviously incur substantial compliance costs in undertaking the liquidation, the need to transfer of commercial contracts and the overall added complexity.

26. A similar result arises under the alternative of grossing up the imputation credits. Using the above example, as opposed to a capital loss if there were simply non-deductible losses, such as revenue expenditure that was not tax deductible, a similar result occurs. That is:

Profits		138,889
Tax at 28%		38,889
Profits after tax		100,000
Non-deductible expenditure	-	50,000
Shareholder's funds/net assets		**50,000**
Sale value		50,000
Gain on sale of shares		50,000
Retained earnings		50,000
Imputation credits		38,889
Gross up of imputation credits		138,889

27. Under the proposals, the taxable income is the greater of the retained earnings ($50,000) and the gross up of the imputation credits. Given the non-deductible expenditure the grossing up of the imputation credits gives rise to taxable income of $138,889 whereas the company was only sold for $50,000.

28. The above examples also highlight the effect of the shareholder deriving all the income in the year of sale. Consider an example where a company earns $150,000 each year. Each year the company pays a salary of $100,000 therefore leaving in the company $50,000 (before tax) to invest in stock, plant and machinery. After five years of retained $50,000 (before tax), the company will have retained earnings of $250,000 less tax of $70,000 (at 28%), that is retained earnings of $180,000. If the company is sold, at the end of year 5, the taxpayer will have total taxable income of $100,000 salary and $180,000 dividend. That is $280,000 of which $100,000 is taxed at 39% (the excess over $180,000). In all the years the taxable and the company never had combined income over $180,000. In this case there is no issue of anyone avoiding the 39% tax rate but income is taxed at the 39% rate.

Proposals are not practical

29. These rules come with substantial complexity and are not practical to implement or only implementable by incurring substantial compliance costs.

30. The proposal requires the calculation of the retained earning at the time of sale. This will require detailed financial accounts at the sale date during the income year when shareholding changes take place. In the situation where the controlling shareholder is progressively selling down to employees through the income year, this will require detailed accounts to be prepared throughout the income year. This comes at a substantial compliance cost or transactions will be aligned with income tax balance date or transactions will not occur at all.

31. The cost of detailed financial accounts also will require of level of precision that for many companies is only undertaken at year end. This includes:

    a. Depreciation calculations to shareholding change date.

    b. Physical stock takes.

    c. Accrual and provisions including calculation of tax liabilities, holiday provisions, shareholder salaries etc to the date of sale.

32. There will likely be a range of avoidance rules to prevent taxpayers artificially reducing retained earnings to reduce the tax payable by the sale of shares by major shareholders (such as the over-provision for expenses). The scope and breath of these rules is not yet known so it is not possible to provide detailed comments other than this will raise compliance costs.

33. The calculation of the imputation credits at the point of sale has also not been fully canvassed in the Document. This will likely need to be adjusted for tax liabilities post the sale or outstanding tax refunds. There is no comment on how tax liabilities from the last income year to the point of sale are to be treated. For example, if there are material profits from the last balance date but no tax has yet been paid with respect of that period, is some adjustment required?

Economic distortion caused by the proposals

34. Many companies initially start with insufficient capital. They accumulate capital through the retention of taxable income, that is retained earnings. The proposals in the Document will create a tax cost for many commercial transactions and as such it could create a barrier to undertaking ordinary commercial transactions. It is proposed that the tax will be paid when any controlling shareholder sells shares in the following situations:

    a. Introducing employees

    b. Introducing another partner

    c. Succession planning

35. When introducing the above shareholders, the major shareholder will be taxed on the retained earnings portion of the shares being sold. Most small and medium size companies build capital by retaining profits so that the level of retained profits will be significant, especially if retained earnings are accumulated over a number of years. The retained earnings are likely to be invested in plant and machinery etc. necessary to operate the business.

36. When a controlling shareholder sells even a small portion of their shares there could be a significant cash liability even though the funds are still in the company. This could be a significant barrier for controlling shareholders selling shares to employees, new partners or combining businesses.

Conclusion to taxing the sale of shares

37. Conclusion:

    a. This is a significant tax imposition on the sale of many companies. While portrayed as taxing those avoiding the 39% tax rate, these proposals go much further and will impact shareholders that have never been on the 39% tax rate.

    b. For many small and medium size companies these proposals will create a barrier to introducing new investors, rewarding employees with shares and succession planning. This is a material economic distortion that is not discussed in the document.

    c. These rules will come with extreme complexity and therefore compliance costs.

Personal services attribution rule

38. It is also proposed to change the personal services attribution income. Where a company earns taxable income it is taxed at 28%. Generally, where the income from the company is derived from the <u>services of one person</u> and <u>80% or more of that gross income comes from one customer</u> and there are <u>no substantial assets</u> (costing greater than $75,000), then the income of the company is taxed at the person's individual marginal tax rate as opposed to the corporate tax rate. This is referred to as the personal services attribution income.

39. The personal services attribution rule was targeted "at people who would normally be regarded as employees" (para 6.4). More specifically this was aimed at structures where a single individual provides services income to one client/customer operating through a corporate structure to gain the advantage of the lower corporate tax rate.

40. The proposed changes to the personal services attribution rules fundamentally change this to apply the rule to most small services business operated through corporate structures. The rule will no longer be limited to contractors who are in substance employees.

80% of income from one client/customer

41. The first change is to remove the requirement that the company receives 80% or more of its income from one customer. This materially expands the rule from contractors operating through corporate structures to businesses. This is best demonstrated in example 8 in the Document. The Document states (papa 7.1, emphasis added):

> Example 8 illustrates how there might also be an issue when a taxpayer that performs personal services has multiple customers.

> **Example 8: Personal services business with multiple customers**
>
> Bill is an accountant who is the sole employee and shareholder of his company, A Plus Accounting Ltd. The company pays the 28% corporate tax rate on the income from accounting services provided to clients and pays a salary to Bill of $70,000. Any residual profits are either retained in the company or are made available to Bill as loans.

42. Currently, the personal services attribution rule will not apply to Bill as the company does not receive 80% of his income from one single client. From the facts, Bill is operating a business with numerous clients.

43. An obvious conclusion from the facts is that Bill is using the retained profits to finance debtors, computers, furniture and other fixed assets. Whereas other businesses can finance these business assets from tax paid profits at 28%, the proposal would mean that this is not available to Bill. This is directly removing the corporate tax rate for small businesses. There is not even the necessity for Bill and the company combined to be earning over $180,000 when the 39% tax rate applies.

44. The above example suggests that the profits may be advanced to Bill as a loan. There are comprehensive dividend rules to negate any tax benefit arising from such a structure of loans to shareholders. These comprehensive dividend rules have been a feature of the tax framework for a considerable period of time and there has been no suggestion they are not working correctly in removing any tax benefit. The tax benefit of the loan is not explained, neither is the application of the deemed dividend rules. There is simply no basis to suggest a change is required due to the loan.

45. It is submitted that the removal of the requirement to have at least 80% of the income from one client/customer is wrong.

Removal of the 80% individual supplier rule

46. The personal services attribution rule requires 80% of the "effort" to provide the services to come from one person (in the above example it is Bill). "Effort" is in proportion of the income of the business the one person derives.

47. It is proposed to reduce this "80% effort test" down to 50%. That is, the person providing the services currently has to provide at least 80% of the effort. It is proposed to reduce this down to 50%.

48. With the requirement that 80% of the income comes from one client (as above), the "80% effort test" makes sense. <u>With the removal of the requirement that 80% of the income comes from one client, the reduction of the "80% effort test" to a 50% test means that small service businesses with one or potentially two or three employees cannot access the 28% corporate tax rate.</u>

49. If there is only one shareholder employee providing the services, then the personal services attribution rule would naturally apply (whether an 80% or 50% effort test). Reducing the 80% effort test down to 50% means where the company has one, two or three employees (including the shareholder employee) then the rules will only apply if the shareholder employee is providing at least 50% of the "effort". This is obviously extremely subjective. It requires detailed analysis of whether the shareholder employee contributed at least 50% of the "effort" to generate the income of the company and in many cases this will not be measured.

50. If there is an accounting business with say one accountant and say two other employees, this business will be prohibited from retaining profits with the tax rate of 28% if the accountant generated 50% of more of the "effort" to derive the income. <u>Why such a business cannot access the 28% corporate tax rate when similar business with more employees can is not explained.</u>

51. For the reasons outlined above, we submit there should be no changes to the existing rules.

Substantial asset test

52. The personal income attribution rules do not currently apply if the business has substantial assets used to generate the services income. In most situations there is a $75,000 threshold when an asset becomes substantial and the personal income attribution rules do not apply if that threshold is exceeded. For example, a farming contractor that provides services such as cutting grass is not caught by the personal attribution rules if they have a substantial assets such as the tractor. Currently, they can access the corporate tax rate retaining profits at the 28% tax rate to repay the loan to buy the tractor.

53. There are two proposals with respect of this exemption from the personal services attribution rules. The first is to increase the $75,000 test to either $150,000 or $200,000 due to "the cost of business assets today." (para 7.7). The second proposal is to remove passenger vehicles or luxury vehicles (para 7.8).

54. There is no explanation for the increase in the threshold from $75,000 to either $150,000 or $200,000. There is no explanation what forms "the cost of business assets" noted above.

55. Removing "passenger vehicles" is also without policy rationale. If the substantial asset is a bus, it is unclear why the taxpayer cannot access the corporate tax rate to finance the cost of the bus. Likewise, if

the business is that of a shuttle van, there seem no policy rationale why such taxpayers will not be able access the 28% corporate tax rate for reinvested profits.

56. The proposed exclusion of luxury vehicles has even less policy rationale. First, there is no explanation when a vehicle would be classified as a luxury vehicle. The luxury vehicle does not seem limited to passenger vehicles and could therefore include "luxury" trucks, diggers or tractors. Why such a prohibition is required is not explained.

Conclusion to personal services attribution rule

57. Conclusion

    a. This is a significant change expanding the personal services attribution rule from contractors servicing a single client to small businesses servicing many clients. The case for the expansion is simply not made in the Document.

    b. There seems no justification for removing the 80% "effort" test to include small business with one, two or three employees.

    c. There is no justification to excluding passenger vehicles or luxury vehicles from the definition of substantial assets.

    d. These rules will come with extreme complexity and therefore compliance costs.

    e. These changes should not proceed.

Final comments

58. Together, these proposals disproportionately increase taxes on small businesses and in effect represent a substantial break from the Labour Party's pre-election promise to not introduce any new taxes beyond those in the Party's election manifesto.

Yours sincerely,
New Zealand Taxpayers' Union Inc.

s 9(2)(a)

Louis Houlbrooke
Campaigns Manager
s 9(2)(a)

CANTIN CONSULTING

Cantin Consulting
s 9(2)(a)

Dividend Integrity and personal services income attribution
c/-Deputy Commissioner
Inland Revenue Department
By email: policy.webmaster@ird.govt.nz
27 April 2022

Dear Sir,

Dividend Integrity and personal services income integration – a Government discussion document

Thank you for the opportunity to respond to the discussion document. I expect there will be submissions on the detail of the proposals. I focus on questions of principle.

Concerns

My concerns, broadly, are two-fold:

- The piece-meal nature of the proposals risk further complicating the rules and making the tax system more incoherent;
- The evidence for the changes is uncertain and how the evidence is described is mis-leading.

Email: s 9(2)(a)

Dividend integrity and personal services income attributiion – a Government discussion document 27 April 2022

The Minister of Revenue recently stated that he has no idea what the effective tax rate (on economic income) of taxpayers is. Despite that, the discussion document draws conclusions from limited information. This is used to support the discussion documents proposals.

The results that are observed are because of structural features and choices for the tax system. If a person uses a company to operate a business or a trust or portfolio investment entity (PIE) to make investments, the tax system operates in a particular and chosen by parliament way. To be able to achieve these results:

- there must in reality be a company, a trust or a PIE. These all have a combination of tax and other rules which govern how they can and must operate;
- the number of companies, trusts, and PIEs is irrelevant to the tax outcomes and is neutral as to the tax outcomes. (From a purely tax perspective, only one company or trust is required to produce the company or trust tax rate. The number of them must be driven by other requirements.)

Apart from the personal services attribution rule, personal and "entity" integration is not a consistent principle of the New Zealand tax system. In fact, the reverse can often be the case. For example, the Look Through Company (LTC) regime prevents integration through the LTC qualification rules. Further, the dividend rules mean that a capital gain made by a company cannot be distributed to shareholders. Significantly, the PIE rules also have a tax rate difference of 11% for those with taxable income of greater than $180,000. (I note this is excluded from consideration as "savings policy". This does not mean it is not contrary evidence to the integration principle implied by the discussion document.)

Despite this the discussion document proceeds from the assertion that results which do not align with integration "avoid" the application of personal marginal tax rates. That should not be the conclusion or the starting point. The better question is whether integration should be the principle.

If it is, the questions that arise include:

- when should the personal tax rate apply? Should the company and personal tax rate differential should be preserved? Reinvestment of company profits at a lower tax rate may be desirable so that integration does not apply as a company makes taxable income. If there is a desirable difference, do the current dividend rules support the reasons for a differential rate? (Use of company profits by shareholders without a dividend being taxed is contrary to the reason for a differential tax rate.   If the shareholder has use of the company profit, it is not reinvested in the business. Ostensibly, this is a driver for the discussion document's proposals. However, the

Email: s 9(2)(a)

assumptions made and conclusions drawn do not make a convincing case for the proposed deemed dividend rules.

- should the LTC regime be relaxed to allow greater use of the regime?
- should a company distribute capital gains without it being a dividend? If integration is the objective, there is no reason why company capital gains should be treated as dividends.
- Should shareholders be able to use company tax losses? If integration is the principle, then company tax losses are losses of the individual shareholders.

These questions should be considered rather than proceeding with further ad hoc changes. (Note that some of these questions arise from the proposal in any case. For example, if taxable income is deemed distributed why are tax losses not deemed attributed on sale of shares?)

If the proposals proceed, there will be a partial integration principle - integration would not apply to investments in widely held companies or PIEs and integration would only arise on disposal of shares. The discussion document does not provide a convincing argument for why this should be the case.

Other observations

The discussion document, consistent with Government policy, rules out a comprehensive capital gains tax. I note that this constrains the policy choices and means potentially better policy cannot be pursued. (“Better” in the sense of coherence.)

As an aside, I note that US dividend treatment may not be the best example for New Zealand tax treatment. The context is different. The US has a classical company tax system, capital gains tax and has specific treatments (for example, for share buybacks) which both seek to tax and exempt distributions from companies. This is different to the New Zealand system and approach.

General comment

In short, comprehensive integration of personal and “entity” taxation should be considered for whether it should be (it currently is not) a principle of New Zealand’s tax system. If it is, there are further changes to tax policy which should be pursued.

However, I expect these concerns will be dismissed. That is, in my view, unfortunate as it reduces the prospects of having a good tax system.

Email: s 9(2)(a)
This is not intended to be and should not be substituted for specific advice. Statements made in this response should be confirmed for your specific circumstances.

I am happy to discuss my comments and questions should that be helpful.

Yours sincerely

s 9(2)(a)

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28 April 2022

Dear David

KPMG submission - Dividend integrity and personal services income attribution discussion document

Thank you for the opportunity to provide feedback on the "Dividend integrity and personal services income attribution" Government discussion document.

General comments

The summary in Chapter 1 states that the integrity measures are intended to limit the ability of individuals to avoid the 39% (and 33%) personal tax rate by diverting their income through entities, in this case companies, which are taxed at a lower rate (28%).

The discussion document proposes:

— That any sale of shares in a company by the controlling shareholder be treated as giving rise to a deemed dividend to the shareholder to the extent that the company (and its subsidiaries) has retained earnings. The deemed dividend amount will be calculated at the higher of accounting retained earnings and the company's imputation balance divided by the company tax rate.

— That companies be required, on a prospective basis, to maintain a record of their Available Subscribed Capital ("ASC") and net capital gain so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation.

— That the "80 percent one buyer" test for the personal services attribution rule be removed.

Our submission is primarily focussed on the first proposal.

There is clear mismatch between the definition of the problem outlined in Chapter 1 of the discussion document and the scope of the deemed dividend solution. The proposed solution goes well beyond addressing the 39% tax rate integrity concerns raised and represents a fundamental change to the operation of the company and dividend tax rules. In our view, the tax rules will effectively discourage reinvestment in the business. This is because there will be a tax rate "wash-up" at the time of sale if profits are retained, with the consequence that a higher marginal rate is likely to apply compared to if the profits were regularly distributed.

There are many reasons why individuals choose to carry out business activities using a company. There are also genuine commercial reasons why profits will be retained and reinvested in the business (such as in plant or other business assets), rather than being paid out as a dividend. The discussion document does not make any distinction, for example, between retained earnings that are reinvested versus held in cash and available for distribution.

The proposal to treat a sale of shares as giving rise to a deemed dividend, to the extent of retained earnings, can also be seen as a form of capital gains tax. This is because it will recharacterise some of the proceeds from the sale of a capital asset as a taxable amount. We note the Government has made clear that it has no intention of introducing a capital gains tax. This is, therefore, a clear overreach.

We believe that further work is needed to significantly modify the proposals. The scope should be appropriately narrowed to address the identified integrity issues and no more. We discuss this in more detail below.

Part I: Sale of shares

Principal submission – the proposed deemed dividend rule should not proceed

The scope of any dividend recharacterisation rule should be limited to transactions where it is clear that the primary driver is converting what would otherwise be a dividend to a capital gain (that is, there is a clear tax avoidance purpose or intention). It is not an appropriate policy outcome to deem a dividend to arise more generally when shares are sold, merely on the basis that the company has retained earnings at the time the shares are sold. This has no regard, for example, to how retained profits have been utilised.

We note that the Income Tax Act 2007 ("the Act") already contains targeted rules to deal with "dividend stripping" (in section GB 1), together with the general anti-avoidance provision (in section BG 1). In our view, the current rules are already sufficiently wide to deal with the stated tax rate integrity problems, provided they are appropriately enforced by Inland Revenue.

The most likely scenario where there could be a dividend stripping risk is scenario A, where the shareholder sells shares of a controlled company to a related company for a loan back. Here, the shareholder retains economic ownership of the company and can use the loan to access the retained earnings of the controlled company without paying any additional tax. We believe the existing dividend stripping rules will be effective in targeting such arrangements.

In contrast, scenarios B and C, which involve the sale of shares to third parties, appear to us to be standard commercial transactions and not undertaken for tax-related reasons. But no such distinction is drawn in the discussion document – the inference is that there is a clear tax motive.

Where there are undistributed retained earnings, this will generally be because the profits have been reinvested and there is no cash available to pay a dividend. On the sale of a business resulting in a greater than 34% shareholding change, any imputation credits will be forfeited. In our experience, if cash balances were held, these will generally be distributed pre-sale. This is because the value of any undistributed retained earnings that will not be sheltered by imputation credits would generally be discounted by the purchaser, who will be inheriting a future tax cost when these earnings are distributed. Therefore, it is not correct to say that a controlling shareholder will receive full value for the value of retained earnings in the business, on sale.

We do not believe legislative changes are required to deem a dividend to arise in scenarios A to C. To the extent that there is clearly dividend stripping in these scenarios, the current rules (sections BG 1 and GB 1) can be applied by Inland Revenue.

If a legislative rule is needed, we strongly recommend it be targeted at scenario A only, as that appears to us the most likely dividend stripping scenario.

Supplementary submissions

In the event the deemed dividend proposal outlined in the discussion document proceeds, we make the following supplementary submissions:

The grossed up undistributed earnings of the company should not be calculated as "the higher of" the accounting retained earnings or the ICA balance dividend by the company tax rate.

We understand that the proposal to use the higher of these measures is because this avoids the potential risk of under-taxation. This is not a valid justification. Using the higher of these two measures is more likely to result in over-taxation, in our view, including for some of the reasons outlined below.

Accounting retained earnings (less non-taxable capital gains) is not an appropriate proxy for the grossed up un-distributed taxed earnings of the company.

The accounting retained earnings (less non-taxable capital gains) is not an appropriate proxy for the following reasons:

- Generally, transactions involving the sale of shares will not happen on the last day of the financial year. Therefore, the accounting retained earnings balance will not be calculated as at the date of the sale of the shares. A requirement to prepare accounts and calculate retained earnings to the time of sale would impose additional compliance costs on taxpayers.

- There is often an element of subjectivity in the calculation of accounting retained earnings (for instance, when provisioning for doubtful debts or making inventory valuations). Therefore, there may be an ability to manipulate the accounting retained earnings figure as at the date of the transaction.

- There will be a clear "disconnect" between accounting retained earnings and accumulated profits that have been subject to tax in some circumstances. For instance, if tax depreciation has been calculated at a higher rate than accounting depreciation in respect of an asset, the accounting retained earnings will exceed after-tax profits.

There will be over (double) taxation

- If there is future depreciation recovery income, the proposed rule will result in a deemed dividend without the corresponding imputation credits being available to shelter this. This would result in a double tax impost.

- Companies may have retained earnings that arose when owned by a previous shareholder(s). The imputation credits relating to those past profits will have been forfeited when the shareholding changed to the current owner. Including prior period retained earnings in the deemed dividend rule would result in over-taxation to the current shareholder.

The ICA balance, without adjustments, divided by the company tax rate is not an appropriate proxy for the undistributed earnings of the company

In our view, using the ICA balance divided by the company tax rate is a more workable solution than basing the deemed dividend amount on accounting retained earnings. However, this is only a workable solution if adjustments to the ICA balance as at the date of the share sale are allowed. In particular:

- The ICA balance as at the date of the sale of shares would not reflect the tax paid on undistributed earnings up to that point of time. Adjustments would be required for tax payments and refunds of tax made after the transaction date that relate to the period up to the transaction date.

— The impact of the tax pooling rules on the ICA balance (and in particular the timing of debits and credits to the ICA) needs to be considered.

As noted earlier, there is a risk that shareholders will be taxed at a higher rate than if the earnings had been distributed at the time they arose.

The definition of "controlling shareholders" needs to be narrowed

It is proposed that the changes would apply to "controlling shareholders", including associates and other (non-associated) shareholders that are "acting together". Often share sale agreements will have tag-along or drag-along rights, however the existence of these clauses does not necessarily imply that shareholders are "acting together" (in a control of the company sense).

Any test which requires a determination of whether the exiting shareholder is a controlling shareholder, or not, will be extremely difficult to apply in practice, unless suitably narrowed to those shareholders who have genuine control of the company (e.g. as reflected by their voting interests).

Part II: ASC and ACDA tracking accounts

We support the proposal to require companies 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.

Our preference is for ASC and net capital gain amounts to be determined and reported to Inland Revenue annually (similar to the current annual ICA disclosure requirement).

On the basis that taxpayers would be required to take a tax position when treating a distribution as a return of capital, the statute bar should apply to the information provided. The Commissioner should only be able to dispute the calculation of ASC or net capital gains within the relevant statute bar period (unless no such disclosure has been made).

We also submit that ASC should be applied on a first-in-first-out (FIFO) basis.

Part III: Personal services income attribution

We do not support broadening the personal services attribution rules by removing the single buyer requirement.

The proposed changes to the attribution rules criteria would significantly expand their coverage and potentially capture business activities carried on by a company where the income has not arisen primarily due to the personal services of the shareholder. It is also not clear to us why this change is needed given case law precedent (*Penny and Hooper v CIR (2011)*).

Further information

Please do not hesitate to contact us, Rachel Piper on s 9(2)(a) or Darshana Elwela on s 9(2)(a), should you wish to discuss our submission.

Yours sincerely

s 9(2)(a)

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s 9(2)(a)

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29 April 2022

Dear Paul,

Dividend integrity and person services income attribution – discussion document

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 170,000 members in over 100 countries and regions, including over 2,700 members in New Zealand. We make this submission on behalf of our members and in the broader public interest.

The Government's **Dividend integrity and person services income attribution** discussion paper (the Discussion Paper) proposes the introduction of dividend integrity and income attribution measures to limit the ability of individuals to avoid the top 39 per cent rate (or the second-highest personal income tax rate of 33 per cent) by diverting their income through entities taxed at a lower rate.

We appreciate the opportunity to have spoken with Inland Revenue and Treasury on 8 April to better understand the Government's intention behind the proposed reforms and the practical challenges for Inland Revenue in applying the existing general anti-avoidance rules (GAAR). However, we maintain our view that the proposed changes go well beyond merely targeting individuals with income (or potential income) levels at the higher tax brackets. The proposed measures impose high compliance costs with significant tax consequences for non-adherence and introduce tax distortions into the economic decision-making of corporate business entities.

We do not support the proposed tax rules due to their complexity and widespread impact, in particular:

- The high likelihood that capital gains will be inadvertently subject to tax where taxpayers do not have satisfactory evidence of retained earnings leading to over-taxation
- The imposition of significant advisory and compliance costs on all small business owners while ostensibly seeking to target only a small group of higher wealth individuals with associated entities.
- The proposed calculations to determine the amount of the deemed dividend are extremely complex and we anticipate there will be a number of issues identified when the rules are put into practice
- The potential challenges for businesses and their tax agents, particularly those who are not qualified accountants, to apply the new rules correctly with significant tax costs if not set up, maintained and enforced properly
- The broad proposed scope with a lack of de minimis thresholds or simplified rules
- The limited digital capability of many New Zealand small businesses, thereby creating barriers to accessing the potential benefits of accounting software-driven efficiencies and improved record keeping upon which the proposals depend for effective implementation

- The repurposing of the personal services income (PSI) rules to apply across the gamut of small commercial services businesses, depriving the businesses of profit and the opportunity to retain earnings for business growth
- The continuous limited efforts by Inland Revenue to utilise the GAAR, alternative intervention actions and administrative guidance to influence taxpayer behaviour before seeking significant, complex and disruptive changes to the tax system.

More generally, the Discussion Paper refers to the tensions created in New Zealand due to the absence of a general tax on capital gains. As the Government's proposals increasingly seek to address tax arbitrage by introducing complex and piecemeal measures that distort economic decision making and reduce productivity, we believe that a capital gains tax may be preferable to the current approach.

We also observe that the much-lauded Generic Tax Policy Process (GTPP) is being truncated and condensed to the detriment of New Zealanders. The GTPP epitomises the strength of the tax policy due diligence process in New Zealand and its value lies in the consultative and deliberative manner in which policy is developed to maximise effectiveness and minimise unintended consequences. For such significant proposals, we are concerned that the limited opportunity to consider and test the changes will result in overly complex, very costly and distortionary changes being introduced with limited long-term benefit to the revenue.

Our responses to the questions for submitters in the Discussion Paper are contained in the Attachment.

If you have any queries about this submission, contact Rick Jones, Country Head, New Zealand on s 9(2)(a) or Elinor Kasapidis, Senior Manager Tax Policy on s 9(2)(a).

Yours sincerely,

s 9(2)(a)

s 9(2)(a)

Dr Gary Pflugrath
Executive General Manager
Policy and Advocacy

Mr Rick Jones
Country Head
New Zealand

Chapter 3: Proposal to tax a deemed dividend portion of proceeds from selling shares

Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?

While framed in the context of addressing tax avoidance by higher-income individuals, the deemed dividend proposal generally seeks to more clearly separate capital gains from retained earnings, to ensure that income tax is paid on the latter while maintaining the tax-free status of the former. Currently, the GAAR are available to address dividend stripping cases.

From the perspective of tax system design and ease of tax administration for Inland Revenue, we recognise the rationale behind the proposal to ensure that the full tax base is properly captured. However, we believe that the proposed approach will be costly and unfair in practice.

The proposed mechanics of the deemed dividend rules are exceptionally complicated in their current form. Feedback from our members suggests that the quality, or even existence, of the documentation required to properly establish and maintain records of retained earnings using accounting concepts, imputation credit account (ICA), available subscribed capital (ASC) and/or available capital distribution amounts (ACDA) will be highly variable, particularly for smaller businesses. The Discussion Paper acknowledges these issues in Chapter 4 and the Government should be mindful of the reality of current business practices and the likely prospect of incorrect taxation due to complexity and the lack of historical records.

The scope of the proposed rule is also very broad, capturing small businesses in existence for decades and requiring detailed accounting records to ensure capital gains are properly quarantined. It is likely that capital gains will be inadvertently subject to tax where taxpayers do not have satisfactory evidence of retained earnings, leading to over-taxation.

Should the scope of the proposed recharacterisation rule cover all of scenarios A, B, or C, or only one or two of these scenarios?

We support the scope of the proposed recharacterisation rule being limited to scenario A. The Discussion Paper is focused on the risks arising from transactions between associated entities, so the tax measures should target this particular issue rather than seek to capture all sales of New Zealand businesses.

Scenarios B and C will capture the sale of shares to unrelated companies and individuals. This will impose significant advisory and compliance costs on all small business owners while ostensibly seeking to target only a small group of higher wealth individuals with associated entities.

Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?

As per our response to the previous question, the limitation of the recharacterisation rule to controlling shareholders is appropriate given the nature of the issue the Government seeks to address.

Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?

While the conceptual basis of the proposal may appear simple, the proposed calculations to determine the amount of the deemed dividend are extremely complex. The intention to couple these rules with further complexity by requiring adjustment and monitoring of the ICA and ASC is impractical and inefficient. There will inevitably be increased compliance costs, in particular for smaller businesses.

Whether by design or by default, the current tax proposal will impact a very large group of economically important taxpayers (i.e., small businesses) with limited evidence that they all need to be subject to such complicated tax measures. We note that in prior years, tax administration policy was committed to simplification for small and medium enterprises (SMEs). This proposal stands in contrast to this philosophy by introducing concepts and approaches that introduce complexity and cost.

Given the breadth of affected taxpayers, we suggest that the Inland Revenue first undertake and publish a regulatory impact analysis that also considers existing and alternative options such as the enhanced enforcement of the GAAR and the more active use of Revenue Alerts. This should include estimates of the revenue at risk, the revenue impact of the proposed changes, the affected population and the potential revenue gain from over-taxation due to the deeming rules taxing all but the most evidenced and contemporaneously reported capital gain amounts.

What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two), and which of these approaches do you prefer? Is there an alternative approach you would suggest?

From an accounting perspective, there may be some advantage from improved record-keeping for liquidators in determining the equity component/share capital of a business. However, most businesses never find themselves in a situation of insolvency, thereby reducing the potential benefit of imposing such requirements on all corporate entities.

The primary disadvantage of the suggested dividend quantification approaches is the complexity of the calculations. Many SMEs have been trading for years and finding historical financial accounts and information can be difficult. As their accounts are generally not required to be audited, accounts and records for SMEs may not be maintained with the same rigour and detail as larger companies. Furthermore, small businesses are quite mobile with their choice of advisor, meaning changes in tax agents/advisors can create challenges in the continuity of documentation.

Poor historical accounting practices can result in small businesses paying more tax than they correctly should when:

- the taxpayer can't prove their ASC/ACDA – the default result is that all of the proceeds are treated as retained earnings, deemed a dividend and taxed, or
- accounts can only be partially reconstructed – the balance of the proceeds that can't be shown to be capital gains are treated as retained earnings, deemed a dividend and taxed, even when in actuality that portion should have been recognised as capital gains.

As an example, in Australia a temporary **loss carry back offset** was introduced which required taxpayers to ascertain their franking account balances in order to claim the amount. Our members in Australia reported that there were significant challenges for small businesses and their tax agents to review these accounts to properly ascertain the correct franking account balance, and the ATO undertook significant work to prepare guidance, online tools, forms and education materials to assist advisors and businesses to properly apply the rules.

This experience highlighted the need for the tax administration to invest in and properly manage the implementation of a significant and complex change. It also evidenced the challenges for small businesses to be able to comply, especially when there had been limited prior awareness of the need to accurately and contemporaneously maintain such records.

Given the complexity and substantial tax consequences of an inability to properly ascertain the grossed-up ICA or retained earnings, the need for education and support from the Inland Revenue is even more critical.

Do you agree with the proposed approach (outlined in Example 3) for calculating dividends and ASC adjustments for corporate groups?

The challenge in evaluating the proposed approach is that specific issues with the calculation are usually identified during implementation, rather than in the design phase. Due to the range of potential permutations and combinations of the more simplistic examples provided in the Discussion Paper, it is highly likely that conceptual and practical problems will be encountered as the rules take effect. We recommend that Inland Revenue continue to engage with advisors and businesses to remedy any deficiencies arising during implementation in a timely manner.

We also hold concerns that some tax agents, particularly those who are not professional accountants, may require substantial support from Inland Revenue to ensure that they are correctly applying the rules. Even further support would be needed for businesses that seek to manage their taxes themselves. We recommend that simplified approaches and de minimus thresholds be considered to better confine the impact to targeted taxpayers and reduce the impact on small business.

Is the approach outlined in Example 4 for a sale of one controlled company to another (existing) controlled company (potentially generating a deemed dividend from both companies) correct conceptually?

As per our response to the previous question.

Chapter 5 – ASC and ACDA tracking accounts – Policy options

Whether the proposed transitional rule is appropriate?

We agree that the transitional issue identified in the Discussion Paper, in relation to a lack of contemporaneous accounts and the difficulty in retrospectively calculating ASC and ACDAs, cannot be underestimated. As is acknowledged, some businesses may never be able to properly establish their exact ASC and ACDA and, depending on the scope of the rule, may ultimately be taxed on capital gains. We seek that Inland Revenue takes a practical and reasonable approach when reviewing transactions in the coming years, and some form of assurance from the Commissioner about their compliance approach would help advisors and businesses to adapt.

In terms of transactions occurring after the law is enacted, the proposal appears to assume that businesses and their advisors will properly understand their obligations and establish the relevant accounts and records from that date. We expect that a period of at least 12 months will be needed to:

- prepare Inland Revenue guidance, support products and education sessions for advisors and businesses
- refresh or build advisors' expertise and proficiency in this area
- establish proper record-keeping processes in businesses and closely held groups
- update software products to include and promote this functionality.

Therefore, we recommend that Inland Revenue be provided with the discretion to adopt a tailored approach to implementation, recognising the high compliance burden and tax costs associated with these changes. We also consider digital service providers (DSPs) to be critical to the implementation of the proposed changes, as they will support the transition and help maintain the integrity of records into the future.

However, the information entered into the software needs to be correct, and there is considerable cost associated with the collation and maintenance of this data and associated records. To reduce the overall cost of the proposal, we suggest that the Government consider introducing a de minimis threshold or simplified rules for small businesses.

Whether the Commissioner should be able to reopen a return and on what basis?

We do not support annual reporting to Inland Revenue, but if progressed, we do not agree with an unlimited period of review being made available to the Commissioner.

Given that the ASC and ACDAs become relevant only upon sale/liquidation of the company and there is a taxpayer incentive to maintain accurate records due to the high tax cost of failing to do so, the case for mandatory reporting and providing the Commissioner with an associated unlimited period of review (i.e., Option 1) is unclear.

Where the concern is that the Commissioner will be forced to accept reported ASC and ACDA amounts after the period of review has elapsed, Option 2 provides a more pragmatic solution where the onus is on the taxpayer to maintain records and Inland Revenue is able to consider these as part of the review of the sale transaction. This second approach is similar to that taken for capital gains tax (CGT) in Australia where historical records are required to substantiate the cost base of CGT assets.

Whether the proposal strikes an appropriate balance between compliance costs and tax integrity?

As indicated in our previous responses, we do not believe the proposal strikes an appropriate balance between compliance costs and tax integrity. There is limited data in the Discussion Paper to assess the potential impacts, however, we expect that all businesses will experience increased compliance costs and, of greater concern, there is the real likelihood of improper taxation of capital gains due to weaknesses in many businesses' record-keeping processes. We believe that these costs will outweigh the expected benefit – given that paragraph 1.11 of the Discussion Paper suggests that the Government's concerns are centred on the behaviour of 350 high wealth individuals, but the proposed changes will potentially affect hundreds of thousands of New Zealand businesses and their owners.

At a practical level, businesses who do not use an agent are unlikely to be able to apply the rules properly and we reiterate the importance of ensuring that tax agents and advisors are properly qualified and competent to perform these services given the potential tax costs if done incorrectly. The proposal that a company will be deemed to have their ASC and ACDA to be zero if not reported to Inland Revenue on a timely basis is also extremely punitive and highly disproportionate to the risk sought to be addressed by the Government.

In the future, accounting software will likely reduce the costs and inefficiencies as records are maintained contemporaneously and can be transferred between different tax agents and different software products. However, CPA Australia's **Asia-Pacific Small Business Survey** consistently finds that the current digital capability of New Zealand businesses lags behind the rest of the Asia-Pacific (with the exception of Australia) and that there is limited appetite for investment in technology, particularly for compliance obligations rather than business growth.

The Government should therefore be mindful of the current capacity of New Zealand businesses to absorb greater compliance costs, particularly as they emerge from the events of the past two years. It is important to understand that many businesses are not currently in a position to transform their accounting systems or establish and maintain detailed records for far-off events.

Whether the ASC and ACDA memorandum accounts should be reported in annual returns?

As per our earlier response, we do not support a requirement to report annually to Inland Revenue. The proposed design creates a very strong incentive for the taxpayer to keep contemporaneous records, because if they are unable to do so, the entire sale proceeds including unsubstantiated capital gains will be subject to tax.

Chapter 7 –Personal services income attribution – Proposal

Fundamentally, we do not support the repurposing of the PSI rules to dictate the commercial decisions of New Zealand services businesses. The PSI attribution rule was intended to prevent the recharacterisation of what is, essentially, employment income.

Corporate structures are chosen for a wide variety of non-tax related reasons, and we are concerned that the proposed changes will significantly diminish the economic choices and growth prospects of many businesses. There are a multitude of reasons why companies retain their earnings, including setting aside capital for future growth and investment, to fund business acquisitions, to hire staff or to take risks.

In Australia, the PSI rules are specifically designed to carve out personal services businesses (PSBs) from the PSI regime in recognition of their different economic nature. Anti-avoidance provisions remain available to the ATO to address any mischief in relation to PSBs.

The New Zealand proposal stands in stark contrast to the Australian design by seeking to actively capture businesses under the PSI regime and to remove the safeguards that protect businesses from tax rules restricting their economic choices. In combination, the proposed changes to the PSI test suggest that the majority of small personal services businesses will be required to attribute income to the working person, without regard to the clear economic benefits of corporate structures. Net income will be taxed through the working person at individual tax rates, leaving nothing available to the business to improve the balance sheet.

For start-ups and new businesses in particular, this can significantly impede access to capital, introduce cash flow difficulties and reduce growth prospects. It is also costly, inefficient and contrary to the purpose of corporate entities to expect balance sheets to be supported by injected capital funded from post-tax income of the individual. Such policies begin to significantly distort the functionality of a company, with tax rules effectively removing the prospect of business profit and eliminating the economic benefits of retained earnings.

In our view, the Government should be supporting small business growth and encouraging entrepreneurship rather than demanding businesses retain no earnings so that income can be taxed at higher rates. While this may provide a short-term boost to government revenues, in the long run it will impede business growth and entrepreneurship in New Zealand.

If the Government is seeking to ensure that working persons report an appropriate level of income for the provision of their personal services to an associated entity (i.e., remuneration for their labour), then consideration should instead be given to alternatives such as the introduction of a domestic transfer pricing regime[1]. The administrative approach taken by the ATO in Australia has been to issue **PCG 2021/4 Allocation of professional firm profits - ATO compliance approach**. This Practical Compliance Guideline explains the ATO's approach to assessing the risk that profit allocation arrangements in professional services firms trigger the Australian general anti-avoidance rules, known as Part IVA, and the likelihood of a review. We believe that the decision in *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95 provides Inland Revenue with the basis to manage the risks described in the Discussion Paper, including the use of market rates, by applying the existing GAAR, rather than expanding the PSI regime to all personal services businesses.

We also note that should the deemed dividend proposal be progressed, the PSI proposal becomes unnecessary as any retained earnings not otherwise distributed will be taxed in the hands of the controlling shareholder/working person at individual tax rates upon sale of the business.

Do you agree with the proposed removal of the "80 percent one buyer" test? Why/why not?

The removal of this test will expose a significant number of personal services businesses to the PSI regime. The Discussion Paper does not provide data on the number of potentially affected businesses, nor the expected increase in government revenue.

The Government is proposing that any business – regardless of whether they have one, or one hundred, buyers – will fall under the PSI rules, disregarding the fact that the buyer test can be seen as a proxy for the level of commerciality. A higher number of buyers indicates the business is more likely to carry higher levels of commercial and legal liability risks or hold more valuable business assets, such as client lists or long-term contracts for example.

We are not sufficiently convinced of the economic and policy basis for the proposal, except to divert income from the company to the working person with the result that commercial businesses will be treated as if they hold no

[1] That is, entities would be required to remunerate working persons at market wages to ensure that transactions between related parties remain at arm's length and removing the ability to shield income earned through the provision of labour.

economic value except for the services provided by the working person, merely so that a higher tax rate can be applied.

This conceptual approach does not acknowledge the risks borne by the corporate entity, nor the life cycle stage of the business and presumes that such a structure provides no commercial or economic purpose or benefit. We do not believe that this is the correct economic characterisation of such businesses, and consequently do not agree with the proposed change.

Do you agree with the suggested decrease in the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?

This proposed change further expands the captured taxpayer population to include the many small businesses with a part-time staff. Again, this test can be viewed as a proxy for the intensity of labour provided by the working person. A lower percentage indicates that business income is less likely to be solely generated by the working person, and therefore should not be attributed as employment-type income.

A reduction in the threshold to 50 per cent again disregards the economic value generated by other natural persons participating in the business and significantly constrains the ability of the business to increase its value. We therefore do not agree with the suggested decrease in the threshold from 80 percent to 50 percent.

Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?

Further to our earlier comments on arm's length remuneration, if the issue is the use of corporate structures to reduce an individual's tax liabilities and the proposed changes to the one buyer and natural person supplier tests broaden the application of the PSI rules to virtually all personal services businesses, we question why businesses with a higher asset intensity should be entirely exempt.

In the interests of equity, we suggest that any policy changes affecting remuneration or income attribution apply to all individuals who provide their labour to a related entity, regardless of their level of assets. This ensures that all individuals operating their business through such a structure are treated equitably under the tax laws and that certain taxpayers are not discriminated against simply because of the industry in which they operate.

Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter?

Per our previous answer, we question whether the proposed changes to the PSI rules are an appropriate policy response. Therefore, we do not have a view on the substantial business assets test threshold.

Do you consider the net income threshold should be increased from $70,000 per year to $180,000?

While we do not agree with the proposed changes to the PSI rules, if progressed, an increase in the net income threshold will presumably carve out a large number of taxpayers from the regime. However, predicting annual net income for many businesses can be difficult, so it is likely that many businesses will still have to consider the PSI rules throughout the year due to such uncertainty.

CHARTERED ACCOUNTANTS™
AUSTRALIA + NEW ZEALAND

29 April 2022

David Carrigan
Deputy Commissioner
Policy and Regulatory Stewardship
Inland Revenue
PO Box 2198
Wellington 6140
By email: policy.webmaster@ird.govt.nz

Dear David

Dividend integrity and personal services income attribution

Thank you for the opportunity to comment on the 'Dividend integrity and personal services income attribution' Government discussion document.

The discussion document sets out three options for consideration:

- Treating any sale of shares in a company by the controlling shareholder as giving rise to a dividend to the shareholder, to the extent that the company (and its subsidiaries) has retained earnings.
- Requiring companies to maintain a record of their available subscribed capital and net capital gains, so that these amounts can be more easily and accurately calculated.
- Broadening the scope of the personal services attribution rule, so that the rule captures a wider array of scenarios.

The proposals (bullet points 1 and 3 above) are inconsistent with the problem definition stated in the regulatory impact statement (RIS) and chapter 1 of the discussion document. In our view they would represent a significant change in the way taxation is implemented in New Zealand (akin to a transaction tax based on the attribution of income to the shareholder at their marginal tax rate) rather than being an integrity measure as purported.

> *The Government recently introduced and implemented a new top personal income tax rate of 39% for income earned over $180,000. Tax rates on other types of taxpayers, including companies and trusts, remain unchanged at 28% and 33% respectively.*
>
> *The motivation for this reform was to raise extra revenue in a way that is progressive and does as little as possible to increase taxes on low to middle income earners. The integrity measures proposed in this discussion document are intended to support this objective by limiting the ability of individuals to avoid the top 39% rate (or the second-highest personal income tax rate of 33%) by diverting their income through entities taxed at a lower rate.*[1] *(underlining added)*

Sale of shares

The first proposal to treat the sale of shares by a controlling shareholder in a non-listed company as a dividend to the extent there are retained earnings does not clearly address the problem stated above. Rather it has the effect of introducing a form of capital gains tax by recharacterising sale proceeds from a capital asset. This measure would result in significant overreach, impinge on normal commercial transactions and does not align with stated Government policy.

> ***The Government has ruled out*** *aligning the top personal income tax rate with the company and trustee tax rates or* ***introducing a capital gains tax****.*[2] *(emphasis added).*

We acknowledge the existence of targeted anti-avoidance rules relating to dividend stripping. These are appropriate in circumstances where there is a mischief to address. However, the proposal is focused on controlling shareholders in a wide context whereas the dividend stripping rules apply to all shareholders

[1] DD Summary, page 5
[2] RIS paragraph 27

on a narrower but more targeted basis. In the context of addressing avoidance of the individual 39% tax rate, it would be sensible to review whether the dividend stripping rules are being adequately enforced. Any legislative changes outside this scope are unnecessary. Should this proposed measure proceed it would introduce inefficiencies and complexities resulting in inequitable outcomes. It arbitrarily distinguishes between publicly listed and non-listed companies and provides for different outcomes for shareholders depending on whether they are considered to hold a controlling interest or not. It is our view it especially negatively impacts on the SME sector and may become a barrier to economic growth.

Whether a shareholder is a controlling shareholder may hinge on whether they are treated as "acting together" with other shareholders (a form of aggregation). Proceeding down this route is fraught with practical difficulty. Acting together in our view is very different to a shareholder complying with a "tag along" or "drag along" clause in a relevant agreement. The above arbitrary and inequitable outcomes would undermine the integrity of the tax system.

As noted above, the proposal disproportionately targets small-medium enterprise companies. This is unjustified and directly conflicts with Government's stated objective to promote and support small business.

> *They make up the majority of businesses in NZ and are the backbone of our economy. They employ 29% of our workforce and contribute over a quarter of our GDP. They play a key role in our economy, supporting regional economic growth and supplying larger exporting businesses*[3]

A clear concern within the document is the retention of profits within commercial entities, underpinned by a theme that such is only done to avoid distributions to ultimate taxpayers on a higher marginal tax rate. This is not reality. All business owners (including those who have adopted a corporate structure) should be able to reinvest in and grow their businesses. Tax measures should not be attacking productive investment, rather they should be encouraging such investment. The Productivity Commission actively wants more productive investment.

[3] New Zealand's Support for Small Business May 2018 https://www.business.govt.nz/assets/Uploads/Documents/Small-business-booklet.pdf

In the Government's response to the Productivity Commission's frontier firms report it broadly accepted:

> *its recommendations for lifting incomes and wellbeing through supporting the growth of frontier firms - embedded in supportive innovation ecosystems - to export specialised and distinctive products at scale.*
>
> *Commission Chair Ganesh Nana says, "We welcome the Government's acceptance of the need for "areas of focus" in the economy."*[4]

It is our view that the use of companies and specifically the sale of shares is not prima facie evidence of income being "diverted" to avoid a higher rate of tax. A company is used as a business form so that limited liability may apply (if the rules are followed). A sale of shares in a company does not therefore facilitate the diversion of income for a reduced tax rate but is a commercial decision with tax consequences.

Accordingly, a sale of shares in a company is not a means to avoiding the higher tax rate but, again, will be a commercial decision as to the extent of investment to be made by a shareholder. We further note that a sale of shares has potentially penal tax rate consequences. A sale of a controlling interest will generally mean that imputation credits are lost. This means that subsequent dividends are taxed at the shareholders full tax rate.

As discussed with Officials any proposed integrity measures should solely focus on aligning with the problem definition, that is, taxpayers specifically structuring to avoid the 39% top personal tax rate.

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[4] https://www.productivity.govt.nz/news/government-response-to-frontier-firms/

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ASC and ACDA tracking accounts

In principle CA ANZ supports the proposal to require companies to maintain a record of their available subscribed capital (ASC) and available capital distribution amount (ACDA), i.e., net capital gains. It is sensible, accords with best practice and aligns with Operational Statement OS 22/01.

The discussion document puts forward two possible options:

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

In both cases, if a company does not have records to substantiate its ASC and ACDA these amounts will be forfeited.

Subject to our comments below, our preference is option 1.

Where accounts are reported to Inland Revenue annually, paragraph 5.6 states

> *the Government does not propose placing a time limit on the Commissioner's ability to challenge a return in relation to the ACDA and ASC memorandum accounts.*

We do not support this. The time bar should apply from when the information is filed. It is at this point the taxpayer has taken a tax position. This approach would promote voluntary compliance and has an excellent policy rationale-the certainty that statute bar provides for taxpayers (and the tax administration) unless they fraudulently or wilfully omit information. Furthermore, post business transformation it would be reasonable for taxpayers to expect the ASC and ACDA return to stand the test of time. For example, once a position is validated then it should only be necessary to consider the impact of a change in legislation such as the broadening of the scope of the ACDA rules. It would be reasonable to expect Inland Revenue's system to be capable of holding/retaining all relevant information for all parties to rely on going forward.

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The discussion document proposes the changes will take effect for transactions occurring after the law is enacted. The current law will apply for transactions occurring before this date. In our view the transitional rules are pragmatic.

Personal services income attribution

The proposal to broaden the scope of the personal services attribution rule (attribution rules)

> *would represent a shift in the focus of the rule from narrowly targeting taxpayers who are similar to employees, towards capturing a wider array of scenarios where an individual may use an associated entity as a conduit for selling their personal services to one or more customers.*[5]

CA ANZ does not support broadening the attribution rules.

The policy rationale for the introduction of the attribution rules is set out in the commentary to the Bill[6] introduced in 2000:

> *The bill introduces an anti-avoidance rule broadly aimed at employees who circumvent the top personal tax rate of 39 percent by interposing a company, trust or partnership between themselves and their employer in order to have their income taxed at a lower rate. The rule will attribute what generally is, in substance, employment income to the employee. It supports the general anti-avoidance provisions of the Income Tax Act 1994.*
>
> *The attribution rule will apply for income tax purposes only, and will not have any impact on the commercial and/or legal consequences of transactions entered into by the interposed entity.*

This is reiterated in paragraph 6.4 of the discussion document.

[5] DD Summary Chapter 7
[6] Taxation (Annual Rates, GST and Miscellaneous Provisions) Bill Commentary page 66

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Notwithstanding the time since the attribution rules were introduced there is no evidence that the rules are deficient. The problem definition identified in 2000 is identical to that stated in the discussion document. The proposal therefore is unjustified.

Relaxation of the attribution rules criteria as proposed would significantly expand the coverage of the rules and potentially capture many existing legitimate **business** activities. Fundamentally why should a painter who applies paint to structures for a wide range of customers be treated differently to someone who sells tins of paint to those same customers?

Differentiating between business profits and personal services profits (as per the above example) or worse, deeming all profit to be attributable to one or more persons (as per the below example) disproportionately impacts small-medium enterprise companies.

Smaller professional services practices that are corporatised would also potentially be captured despite having a reasonably broad client base and operating as a business, as set out under *Greive*.[7] The proposed reduction in the one-person supplier rule will exacerbate this situation given the differential in partner/staff charge out rates, the number and level of staff employed, and the type of work undertaken. The proposal to aggregate income earned by relatives for the purposes of this test would additionally discriminate against intergenerational family practices.

Penny and Hooper

In our view Penny and Hooper[8] is fundamentally different from the attribution rules. It is an avoidance case where the salaries paid to the individuals were considered "contrived and artificial". There is no evidence the precedent set by Penny and Hooper and Inland Revenue's Revenue Alert RA 21/01 are inadequate. Taxpayers and tax agents follow the guidance set out in RA21/01 where relevant.

The statements in paragraph 6.16 regarding "significant limitations" when relying on Penny and Hooper does not carry sufficient weight to justify a change in the law.

[7] Grieve v C of IR (1984) 6 NZTC 61,682; [1984] 1 NZLR 101 (CA)
[8] Penny and Hooper v Commissioner of Inland Revenue (2011) 3 NZTR ¶21-014

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Any changes to the attribution rules will result in overreach and impact legitimate commercial arrangements. Again, this outcome would be inequitable.

Overall, we are deeply concerned by the:

- significant disconnect between the stated problem definition and the proposed solutions outlined in the discussion document; and
- lack of appreciation of the impact/overreach that the proposed solutions would have on ordinary commercial arrangements (including the disproportionate impact on the small-medium enterprise sector).

Based on our above comments we do not believe that the proposed measures are required, and that further work is needed to justify expansion of the current integrity measures.

Any decision to proceed should not be taken lightly nor rushed. Given the potential for overreach and the numerous practical problems we identified and discussed with officials it is important that any measure is appropriately scoped and fully considered. To achieve this, we recommend that a dual track process be adopted and what is intended to be taken forward for inclusion in the August Tax Bill be revised down.

We are happy to discuss our submission. Please contact John Cuthbertson.

Yours sincerely

s 9(2)(a) [redacted]

s 9(2)(a) [redacted]

John Cuthbertson FCA
CA ANZ NZ Tax & Financial Services Leader

Scott Mason FCA
Tax Advisory Group Chair

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TROJAN HOLDINGS LTD

29 April 2022

Dividend integrity and personal services income attribution
c/o Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
PO Box 2198
WELLINGTON 6140

Dear Sir/Madam

Dividend Integrity and Personal Service Income Attribution

Trojan Holdings Limited ("Trojan") is writing to submit on the Government Discussion Document "Dividend integrity and personal services income attribution" (the "Discussion Document").

The Trojan Group is a significant South Island base group of companies with interests in transport, tourism, commercial property, technology and other service businesses. These interests are held both wholly within the Trojan Group or as joint venture investments, often as a source of capital to encourage growth in the Queenstown Lakes area. Trojan is a responsible corporate citizen who takes its tax obligations seriously. The group is a significant employer in the Otago region and pays significant taxes across the group. Trojan is submitting because it is concerned about the dividend integrity measures proposed in the Discussion Document including the overreach beyond their stated objective. Trojan's submission is focussed on the proposals in Part 1 of the Discussion Document.

We note the following concerns with the proposals:

- The proposals in Part 1 of the Discussion Document are intended to address dividend stripping where "a shareholder of a company avoids receiving a taxable dividend by selling their shares for a non-taxable capital sum, often without a change in the economic ownership of the acquired company". Trojan submits that the proposed changes are unnecessary in order to combat dividend stripping as there is already specific legislation in place to counter this. Trojan considers that the issue could therefore be addressed through enforcement of the existing provisions together with any necessary refinements to address obvious deficiencies in the existing provisions. This could be combined with extending the existing guidance (which is very comprehensive and clear) to provide Inland Revenue's views on any new areas of concern.

  Well advised and responsible taxpayers such as Trojan will always seek to comply with the existing rules and would therefore welcome increased enforcement and expanded guidance to assist with compliance rather than suffer unintended consequences and increased compliance costs resulting from the current proposals.

  If legislative change is considered necessary, then Trojan submits that this should be more targeted anti-avoidance provisions to cover only the perceived mischief. The current proposal would apply extremely widely and catch a significant number of transactions where there is no tax-avoidance motive and are therefore a clear example of overreach.

- The proposals as currently drafted do not include any exclusions on transfers of shares on the death of a business owner. As a result, the transfer of a business to surviving family members could result in a potentially significant tax liability thus giving rise to an effective death duty/inheritance tax. Similarly, such an effective tax on transfers of intergenerational wealth would have an impact on estate planning and deter existing business owners from transferring to the next generation with potential detrimental impacts for business growth;

- There should not be a different tax outcome from selling shares compared to selling the business and then winding up the company which could be the case under the current proposals. For example, to the extent that a company had excess imputation credits, any deemed dividend on a sale of the shares would be greater than the liquidation distribution.

- The proposals as currently drafted could give rise to differing outcomes for commercial joint venture partners and in particular give rise to tax liabilities on transfers between the JV partners. For example, where a business is struggling and one JV partner wants to buy out the other (e.g. as one wants to try and turn around the business but the other doesn't). In such circumstances, the potential for different tax treatment between a share sale and a wind up could result in one of the parties deciding to wind the business up (with a resulting loss of productivity and jobs) rather than selling their share to the other.

- The proposals in Part 1 appear to be based on an assumption that retained earnings arise as a result of cash being left in a business in order to avoid the owners paying a higher tax rate. The commercial reality is that retained earnings generally fund the business assets which in turns drives growth of the business. This also contributes to a strong balance sheet which enables businesses to grow, create employment opportunities and to better survive cyclical downturns and disruptive events such as the COVID pandemic.

- As a general point, given the recent announcements by the Minister of Revenue we consider that there should be no new tax legislation introduced until the proposed tax principles legislation is enacted. This is necessary to ensure that any new tax legislation does not immediately contravene the tax principles to be codified in the new act.

Please let us know if you have any queries in relation the points raised above.

Your sincerely

Neil Johnston

CFO

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2 May 2022

Dividend Integrity and Personal Services Income Attribution
c/- Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Sir/Madam

Re: Dividend Integrity and Personal Services Income Attribution

I am writing to you regarding the discussion document entitled '*Dividend Integrity and Personal Services Income Attribution*' (referred to as "the Discussion Document"). Specifically, the primary focus of our submission is on the following two policy areas:

1. Shareholders being taxed on the sale of shares in a company to the extent that the company (and its subsidiaries) has retained earnings; and

2. The changes to the personal services company rules that effectively remove when small businesses can use the lower company tax rate.

BusinessNZ accepts that the increase in the top personal tax rate to 39% on 1 April 2021 has meant that the potential for some type of avoidance to take place is heightened. Therefore, in principle we do not have an issue with Inland Revenue investigating certain aspects of tax policy that may be affected by a higher top personal tax rate.

However, in this instance, we believe that the proposals by Inland Revenue go far beyond what the business community would typically expect in terms of pragmatic and justified options to minimise avoidance measures. Instead, they represent a significant regulatory overreach that will likely create several unintended consequences that will directly harm many businesses, particularly small to medium sized enterprises.

Regarding the two issues outlined above that are discussed in the Discussion Document, BusinessNZ, along with the Corporate Taxpayers Group (CTG), sent a joint letter to the Ministers of Finance, Revenue and Small Business on 28 April that specifically outlined the broad concerns of the business community, along with strongly opposing the proposed changes. The joint letter is attached to this submission.

Recommendation: That Inland Revenue take into account the views expressed in the joint letter by CTG and BusinessNZ that was sent directly to Ministers.

We believe the letter accurately covers BusinessNZ's concerns, so we do not intend to repeat what is outlined in it. However, there is one additional point we would like to make for Inland Revenue to consider.

Future steps

As mentioned in the Discussion Document, the review of the current settings is being progressed in tranches. Tranche one sees the current settings being examined, while tranche two will consider trust integrity and company income retention issues. Paragraph 1.18 of the Discussion Document points out that "*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*." Following that, paragraph 1.20 points out that "*a possible tranche three could consider integrity issues for the taxation of portfolio investment income, such as Portfolio Investment Entity (PIE) taxation*." Therefore, beyond the current tranche, a number of policy decisions still need to be worked through in regard to integrity measures associated with supporting the 39% personal tax rate.

Given the broad and consistent position of the business community that runs contrary to what Inland Revenue is proposing with the current tranche, BusinessNZ believes future tranches require greater input from the business community during their early phases of policy development.

We support the release of discussion documents/issues papers as a way in which the views of submitters can be taken into account before any subsequent legislation is brought before Parliament. However, there are instances where additional early testing of ideas/proposals before a consultation document is released would greatly the quality of the policy process. While we understand that timing is often a critical factor when assessing how much consultation can be undertaken, we believe early and meaningful discussions with groups and organisations that typically have a strong interest in the issue can save considerable time later down the track. Therefore, BusinessNZ would like to see Inland Revenue undertake a greater level of early and meaningful consultation regarding the next tranches of the policy process.

Recommendation: That Inland Revenue undertake a greater level of early consultation regarding the next tranches of the policy process.

Thank you for the opportunity to comment, and we look forward to further developments.

Kind regards,

s 9(2)(a)

Steve Summers
Economist
BusinessNZ

Corporate Taxpayers Group

BusinessNZ
GROWING PROSPERITY AND POTENTIAL

28 April 2022

Hon Grant Robertson
Minister of Finance

Hon David Parker
Minister of Revenue

Hon Stuart Nash
Minister for Small Business

Dear Ministers

By email

DIVIDEND INTEGRITY AND PERSONAL SERVICES INCOME ATTRIBUTION DISCUSSION DOCUMENT

Introduction

The Corporate Taxpayers Group and BusinessNZ are writing in respect of the Government Discussion Document "Dividend integrity and personal services income attribution".

As representatives of Business, we are doing so because we are concerned that the dividend integrity measures proposed in the Discussion Document:

- are not justified by their stated objective of limiting the ability of individuals to avoid the 39% (or 33%) tax rate, since that objective can be achieved by enforcement of the existing law. Inland Revenue has in the past two decades had a high success rate before the courts in cases involving alleged avoidance of the top personal tax rate and has settled numerous cases with the benefit of those case law precedents. It is unclear why Inland Revenue now says (as justification for the Discussion Document proposals) that it lacks the resourcing to apply the same laws it has successfully enforced in the past;

- will potentially apply to all business sale transactions, whereas they are more appropriately limited to internal restructuring which avoids the 33% or 39% tax rates, and even then, only if it is established that there is a compliance problem which cannot be solved with Inland Revenue's existing legislative tools (including the existing avoidance, dividend and fringe benefit tax rules) and the audit and data analytic capabilities unlocked by its new sophisticated computer system;

- would impose new costs and complexities on many businesses, the vast majority of which are not engaged in the tax avoidance practices to which the Discussion Document refers;

- would result in some cases in more onerous tax consequences (and greater potential for distortion of economic activity) than would arise under a capital gains tax (which the Government ruled out). For instance, the Discussion Document proposals would result in tax payable when a business is sold at a loss (see example 1 in the Appendix);

- would (given the preceding point) cut across existing tax policy settings that were put in place to remove tax-related barriers to bringing new owners into a business (including the business continuity test that enables losses to be carried forward when a company is sold if a business continuity test is met) and to enabling New Zealand businesses to compete internationally;

- will result in a number of other unfair outcomes, as illustrated by the examples in the Appendix.

We are also concerned that the proposed changes to the personal services income attribution rules will take the existing rules far beyond the “quasi-employment situations” which were originally contemplated when the rules were enacted in 2000. Instead, any labour-intensive small business with multiple customers, such as tradespeople, or (for example) a one or two-person hairdresser or beautician business, could be caught by the proposals.

The proposals could especially disadvantage such businesses while in their start-up phase, during which most of the income comes from the work of the founder and the business may not (yet) have substantial business assets. The founder may wish to retain profits in the company in order to acquire more equipment and take on more staff, but would be taxed at the 33% or 39% rate on profits they retain, while their larger competitors will be taxed at 28% on profits they retain. The proposals would, therefore, tilt the playing field against small labour-intensive start-ups.

Conclusion

Our respective bodies are concerned that the proposals in the discussion document represent a significant overreach and will apply far wider than transactions which have been deliberately entered into in order to avoid the 39% tax rate.

If it is determined that the proposed measures are needed at all, they should be significantly scaled back to ensure they are targeting only the mischief in question, and only once it is established that there is a compliance problem which cannot be solved with Inland Revenue’s existing legislative tools and its sophisticated computer system.

Yours sincerely

s 9(2)(a)

John Payne

For the Corporate Taxpayers Group

s 9(2)(a)

For Business New Zealand

We note the views in this document are a reflection of the views of the two business groups and do not necessarily reflect the views of individual members.

APPENDIX

Proposals would impose new costs and complexities on businesses

Part I of the Discussion Document proposals would recharacterise the proceeds of sale by a controlling shareholder of shares in a company, by deeming part of the proceeds of sale to be a dividend. The proposals would affect the owners of the thousands of SMEs across the country who may wish to sell any level of shareholding in their business.

It is the view of our organisations that in many instances the outcomes under these proposals are equal to, or worse than, the outcomes under a comprehensive capital gains tax.

Below are some examples to illustrate the potential impact of the proposals:

1. A small business owned by a single shareholder had a cost base of $300,000. The business had been successful prior to the pandemic, and the company has retained earnings of $150,000. The pandemic has adversely affected the business's future prospects and the owner, who has reached retirement age, sells the shareholding for $200,000. The owner, therefore, sells at a loss of $100,000, but (under the proposals) would have income for tax purposes of $150,000.

2. A profitable business which reinvests its profits into growing the business by expanding or purchasing new assets will be deemed to provide a dividend to a majority shareholder in the event that any shares are sold; this is regardless of the fact that profits were reinvested/spent by the business.

3. Different owners have different outcomes based on blood relationships and when they exit the business:
   a. Company F is equally owned by Shareholders X, Y, and Z. The shareholders are all siblings. Shareholder Z wishes to sell their share of Company F and Shareholders X and Y agreed to purchase the shares to result in them owning 50% of the shares each. Shareholder Z is deemed to receive a dividend equal to 1/3rd of the retained earnings in Company F because Shareholder Z is deemed to be a controlling shareholder due to being a sibling to the other shareholders.
   b. Company G is equally owned by Shareholders U, V, and W. The shareholders are all friends. Shareholder W wishes to sell their share of Company G and Shareholders U and V agreed to purchase the shares to result in them owning 50% of the shares each. Shareholder W has no tax consequences of selling the shares.
   c. Company G is equally owned by Shareholders U and V. Shareholder V sells their shares to Shareholder U. Shareholder V has no tax consequences of selling the shares.
   d. Company G is owned by Shareholder U. Historically Company G also had 2 other shareholders (V and W). Shareholder U decides to sell Company G to an unrelated party. Shareholder U is deemed to receive a dividend of the full balance of retained earnings in Company G.

4. Company I is a start-up company owned by Shareholders R and S. Company I has invested heavily in research and development. Company I has benefited from the R&D Tax Incentive, receiving $1m (and consequently $1m of imputation credits). While Company I has not yet reached break-even point or become profitable, its future prospects are positive; as such Shareholders R and S wish to sell the business to pursue a new innovative idea. Shareholders R and S are deemed to receive a dividend of up to $3.57 million ($1 million ICA balance divided by the company tax rate) when they sell Company I to its new owners.

The above examples demonstrate the clear over-reach of the rules and the potential for inappropriate results based on slightly different fact patterns; we can provide more examples if required.

Jim Gordon Tax Limited
s 9(2)(a) [redacted]

29 May 2022

The Deputy Commissioner
Policy
Inland Revenue

By email

Dear David

The dividend integrity etc. discussion document

To say that this discussion document is disappointing is an understatement. The dividend integrity measures are ill-conceived and have significant over-reach, *Penny & Hooper* is misrepresented, and the extension of the attribution will inappropriately diminish horizontal integrity and also has over-reach.

Submissions

As part of this submission, I attach a more recent version of the PowerPoint I shared with tax policy officials a few weeks ago. My specific submission follows:

1 That the policy teams of IRD and Treasury ensure that they have available appropriately qualified analysts. This is not to doubt the ability and qualifications of present analysts, but rather, it the DD makes it clear that their skills do not include the area of SME accounting and taxation.

2 That Ministers and officials allow appropriate time for analysis to be completed before tax proposals are published. It is clear that the DD has been rushed and limited time was available for its development. It is important to the greater good of New Zealand that process of developing tax policy has credibility. Currently this seems to be in doubt, and this DD exacerbates that lack of credibility.

3 That while I acknowledge an issue with dividend stripping in the associated persons context, the dividend integrity proposal goes far too far and will result in arbitrary and capricious outcomes. Refer to the PowerPoint for examples.

4 That further, more specific, legislation is not the best way of dealing with dividend stripping. There are many permutations and variations of transactions that can result in dividend stripping. It will be impossible to codify these. The use of the present anti-avoidance rule is the only way of enforcing the fact that dividend stripping is avoidance and appropriately dealing with these permutations and variations. Remember also that presently SMEs are avoiding and evading significant amounts of taxation because they are not audited. A more specific anti-dividend stripping rule will often be ignored. More enforcement is needed.

5 That I agree conceptually with the ASC and capital gains recording proposals.

6 That real thought needs to be given to the interaction with the time bar and the method of recording the details of ASC and capital gains. This is a wider issue, but it would benefit from some attention.

7 That ASC changes and capital gains be required to be disclosed in detail in the company's financial statements, and that the company be required to keep its financial statements indefinitely. This could simplify recording for both the company (which has to note this detail in the financial statements anyway) and the IRD. [If this methodology was adopted for trusts, who should keep their annual financial statements indefinitely, the new trust data requirements could be significantly more easily dealt with.]

8 That, if cases are going to be quoted, they be fairly represented. As noted above the DD misrepresents *Penny & Hooper*. It is much more correctly summarised Revenue Alert RA 21/01. I would have thought that IRD policy officials were bound by technical departmental analysis. Certainly, they should not ignore that analysis and do

their own. In this context I accept the DD is technically a Ministers' document, but I still believe that the point is fairly and correctly made.

9 That the DD should have been clear in detailing the targeting of the revised attribution rule. For example, the plumber and his or her apprentice seem to be caught, whereas the plumbing company down the road that is owned by four plumbers is not. How does this plumber even know that they might be affected by the DD, especially given the DD's targeting of certain SMEs is not even disclosed in the DD? [I accept that this targeting may not have been intentional, but it is a fact].

10 That any revision of the attribution rule should carefully consider the horizontal equity effects. For example, it seems fair to ask the question of why monies retained for expansion of the company (trading stock, debtors and plant and equipment) should be taxed at the shareholders marginal tax rate by some plumbing firms and not others.

In contrast, I have little concern when a revised attribution rule is applied to professionals who have only a small amount tied up in debtors, trading stock and fixed assets and when they or their families are receiving the income alienated (a la *Penny & Hooper)*. However, I acknowledge that this will be difficult to codify and would amount to more than a simple revision of the attribution rule.

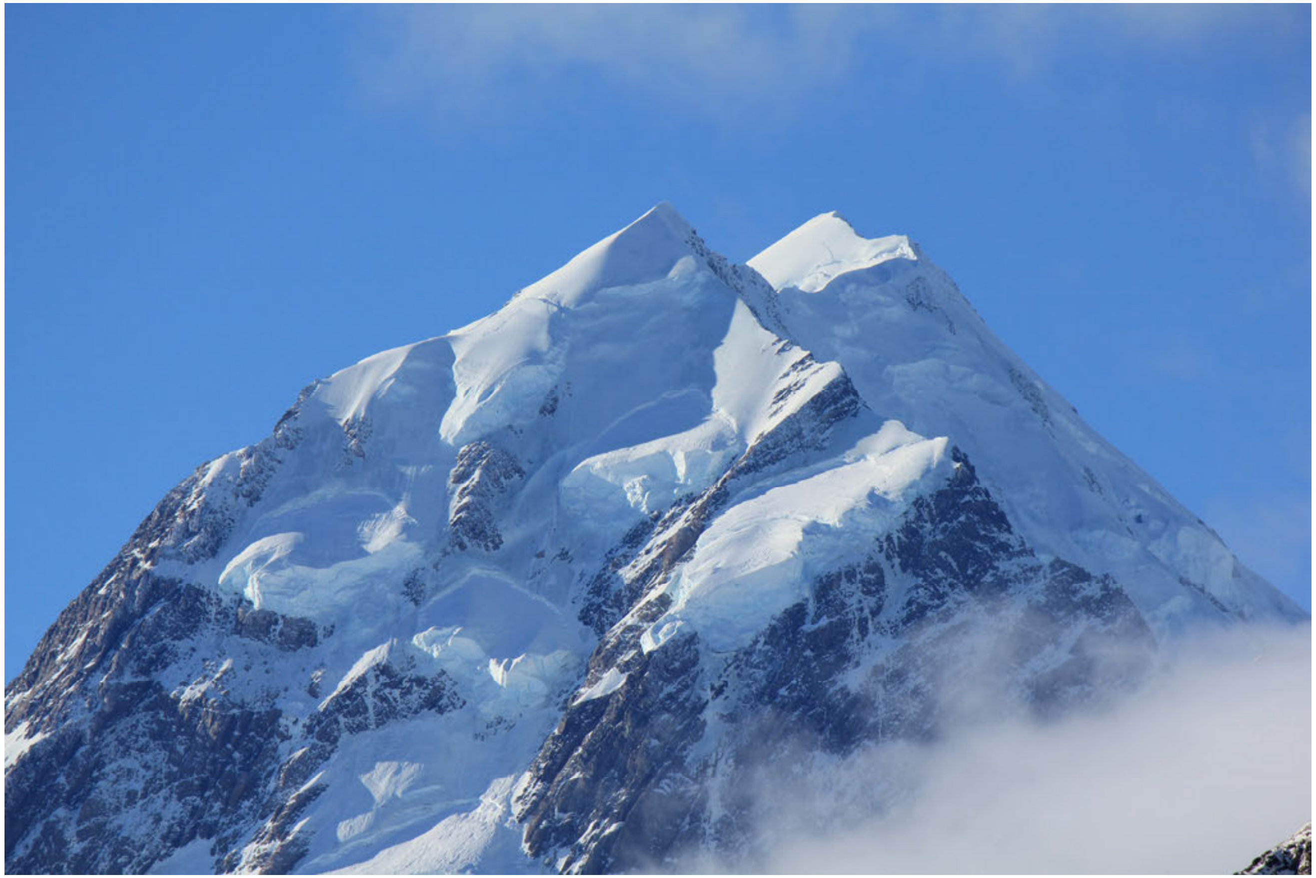
As always I am happy to discuss any aspect of this with you or your tax policy colleagues.

Yours sincerely

s 9(2)(a)

Jim Gordon

Director, Jim Gordon Tax Ltd



Observations on the dividend integrity discussion document

April 2022

Jim Gordon, Jim Gordon Tax Ltd

Topics

- Introduction to the discussion document
- Contents
  - ASC and capital profits
  - The modified attribution rule
  - Dividend integrity
    - The objective
    - The proposal
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    - Examples of operational issues

Introduction

- In March 2022 Government released a Ministers' discussion document titled "*Dividend integrity and personal services attribution*" (the DD).
- Submissions close towards the end of April – the standard 6 weeks.
- At least the dividend integrity part of this is intended to be in a tax bill to be introduced in August, with the objective of enacting it in early 2023.
- There is a very short period of time for officials to analyse submissions and draft legislation.

The DD – the objective

The stated objective of the DD is to limit "the ability of individuals to **avoid** the top 39% [marginal tax] rate (or the second-highest personal income tax rate of 33%) by **diverting** their income through entities taxed at a lower rate".

This is an understandable objective.

Further, it arguably points to codification of existing law to discourage certain forms of avoidance – perhaps a la the MMS legislation.

Available subscribed capital (ASC) and available capital distribution amount (capital profits or ACDA)

- In certain circumstances amounts can be distributed by a company tax free – ASC on a qualifying distribution and both ASC and ACDA on a liquidation.
- Officials are understandably proposing that ASC and ACDA amounts be confirmed annually by companies with the historical stuff included if possible.
- I agree with this. The issue is how to operationalise it – I don't further discuss this.

The modified attribution rule

- This is an attempt to codify *Penny and Hooper* so that income from personal services is attributed to the individual who performed the services.
- The targeting is unclear – does it apply to the plumber who employs an apprentice? If so, do they know the need to make submissions?

Penny and Hooper

- The DD misrepresents *Penny and Hooper*. The case is not about inadequate salaries – it is about the alienation of personal services income **while still spending the income**.

- A surgeon who operates through a company and draws no salary may not be committing tax avoidance?
- A surgeon who receives 75% of the net profit of their operating company with the other 25% being left in the company not be committing tax avoidance?

In both cases further enquiry is needed.

Dividend integrity – the objective

The stated objective of the DD is to limit "the ability of individuals to **avoid** the top 39% [marginal tax] rate (or the second-highest personal income tax rate of 33%) by **diverting** their income through entities taxed at a lower rate".

- The dividend integrity proposal goes far further than this and will grossly over-tax a number of shareholders who are neither **avoiding** tax nor **diverting** income
- Further, the DD has limited details of how the dividend integrity proposal will be operationalised and there will be problems here

Dividend integrity – the proposal

- When a shareholder (with or without associated persons) controls a company and sells shares they (the shareholder) have a potential tax obligation.
- The tax obligation is based on the higher of:
  - The vendor's share of retained earnings (R E), grossed up for the ICA balance (e.g. $72 + $28 = $100)
  - The vendor's share of the ICA balance grossed up to get to the pre-tax income (e.g. $28 / .28 = $100)

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Dividend integrity – who is affected

The main group affected will be family owned companies, the vast majority of which will be SMEs

- SME family owned companies couldn't have been more specifically targeted if someone set out to do it deliberately, but I accept that this wasn't deliberate

Dividend integrity – a transaction tax

The dividend integrity proposal is a transaction tax

- Thus it will interfere with everyday ordinary transactions and cause economic distortions

- It is interesting that the DD doesn’t acknowledge this

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Dividend integrity – the examples

- The following examples presume that 100% of the company is sold. The over-taxation examples are first, followed by the operational examples
- They will all occur in practice
- “RAP” is revenue account property

Dividend integrity over-taxation examples

1. A capital gains tax
2. An arbitrary and capricious tax
3. Taxation of revaluation reserves from RAP
4. Capital losses
5. Taxation of no gain – 2 separate examples

Example 1 – a capital gains tax

Core example	31/3/2021	
Share capital – ASC	$1,000	
Retained earnings	$800	
Shareholder's funds	$1,800	

On its creation the company had capital or $1,000 and a bank loan of $800. For the loan to be repaid the company must sell assets, retain earnings or obtain further loans or capital. In this case, as is common, it retained earnings to repay the bank loan.

At no stage has the shareholder overdrawn their current account.

Given that there is no avoidance or income diversion the sale of the shares for $1,800 should not, from a tax policy perspective, cause any tax to be paid by the shareholder, unless it is intended to tax capital gains. Under the dividend integrity proposal the shareholder is taxed on $800 (plus any ICs).

Example 2 – an arbitrary and capricious tax

	Core	1	2	3
Share capital – ASC	$1,000	$1,000	$1,000	$1,000
Retained earnings	$800	$800	$800	$800
Shareholder’s funds	$1,800	$1,800	$1,800	$1,800
Sold for	$1,800	$2,500	$900	$700
Shareholder’s taxable income (plus any ICs)	$800	$800	$800	$700
Results from scenarios 2 & 3 are clearly arbitrary and capricious				

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Example 3 – revaluation reserves

	31/3/2021	
Share capital – ASC	$1,000	
Retained earnings	$720	
Shareholder's funds	$1,720	

The retained earnings come from a revaluation of RAP. Thus no tax is currently payable by the company, but future tax has been provided for. This results in double taxation. The company has $280 to pay when the RAP is realised and the shareholder has to pay tax now on the $720 at their marginal rate.

Why should the shareholder's tax depend on whether a revaluation of RAP is done? This is especially given that there is no requirement for assets to be at valuation? Contrary to what is implied in the DD IFRS/GAAP is not used or required to be used by say 95% of New Zealand's companies and probably by 99%+ of NZs SMEs companies. These companies can chose to value RAP at tax book value, cost or market.

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Example 4 – capital losses

	31/3/2021	
Share capital – ASC	$1,000	
Retained earnings	$720	
Capital losses (realised or unrealised)	-$800	
Shareholder's funds	$920	
If the shareholder sells the company for $920 they have made an actual loss of $80 ($1,000 in, $920 out), However, the shareholder's deemed dividend income is $720 grossed up for any ICA credits. If the company was liquidated there would be no dividend. This results in taxation where the shareholder has made no gain.		

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Example 5 – taxation of no gain – 1

	31/3/2015 & 2021	
Share capital – ASC	$1,000	
Retained earnings	$800	
Shareholder's funds	$1,800	

On its creation the company had capital or $1,000 and a bank loan of $800. For the loan to be repaid the company must sell assets, retain earnings or obtain further loans or capital. In this case, as is common, it retained earnings to repay the bank loan.

The present vendor shareholder purchased the company on 1/4/2015 for $1,800 and sold it on 1/4/2021 for $1,800. The retained earnings are all from pre-acquisition profits. At no stage have any of the shareholders overdrawn their current accounts.

Given that there is no avoidance or income streaming the sale of the shares should not, from a policy perspective, cause any tax to be paid by the vendor shareholder. Further, the present vendor shareholder has made no untaxed gains over the period they owned the company.

Example 5 – taxation of no gain – 2

	31/3/2021	
Share capital – ASC	$1,000	
Retained earnings	$NIL	
Shareholder's funds	$1,000	

On its creation the company had capital or $1,000 and made widgets using a novel method. In its first 5 years it made real income and paid the shareholder a good salary and retained after tax income.

At no stage was there an overdrawn shareholder current account.

The market caught up and for the next 5 years the company made losses that reversed its retained income.

The company is now sold for the amount the shareholder originally put in as capital - $1,000. Why should the shareholder be deemed to have received a dividend based on the grossed up ICA balance which was created when the company made its profits? The result is over-taxation.

Dividend integrity operationalisation issues

5. When the shares are sold mid-year how is the retained earnings measured?

6. How does the vendor get knowledge of R E and ICs after they have sold?

7. How and when is the ICA balance measured?

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Example 5 – how is the retained income measured?

	31/3/2021	31/3/2022
Share capital – ASC	$1,000	$1,000
Retained earnings	$800	$8,000
Shareholder's funds	$1,800	$9,000
Shares are sold mid-year – which retained earnings balance is used? What if the purchaser has changed the modus operandi of the company after he or she acquired the company which caused the pattern of retained earnings to change significantly?		

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Example 6 – vendor knowledge of R E and ICA?

	31/3/2021	
Share capital – ASC	$1,000	
Retained earnings	$800	
Shareholder's funds	$1,800	
Shares are sold 31/3/2021 or 1/4/2021 – how does the vendor find out what the retained earnings and the ICA are as they will have no access the company's books? The company accounts may not be done for another 12 or even 24 months!		

Example 7 – how & when is the ICA balance measured?

	31/3/2021	
Share capital – ASC	$1,000	
Retained earnings	$720	
Shareholder's funds	$1,720	
Shares are sold 31/3/2021 or 1/4/2021 – but the tax on the income is only paid on P3 (after 1/4/2021). This results in double taxation. The company has $280 to pay and the shareholder has to pay tax on the $720 at their marginal rate.		

JIM GORDON TAX

Dividend integrity and personal services income attribution
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29 April 2022

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

To the Deputy Commissioner, Policy and Regulatory Stewardship

We appreciate the opportunity to comment on the Government's discussion document *Dividend integrity and personal services income attribution* (the **Discussion Document**) which addresses dividend avoidance, available subscribed capital (**ASC**) and available capital distribution amount (**ACDA**) tracking accounts and personal services income attribution.

I. Summary

We understand the Government's desire to ensure the 39% personal tax rate is effective in raising extra revenue and that share sales and interposed service entities are not used to avoid this top tax rate. However, we consider the proposed share sale and personal services changes outlined in the Discussion Document would significantly undermine the coherence of New Zealand's tax system. In particular, we consider that:

- The proposed deemed dividend rule goes beyond an avoidance measure, it is horizontally inequitable, would disproportionately impact small businesses, and could have unintended consequences including creating several operational issues. Furthermore, what is being proposed is a fundamental shift in the scheme of the New Zealand tax system in that it disregards the separate legal identity of different entities and is moving towards the spectrum of full integration.
- The proposed changes to the personal services attribution rules go beyond the parameters of *Penny & Hooper*, as crucial to the outcome of that case was the payment of "artificially low" salaries to the suppliers of the services - this does not appear to be a factor contemplated by the proposed changes.

Regarding the ASC and ACDA "tracking accounts" proposals, we are broadly in favour of option one (i.e. the requirement for taxpayers to maintain tracking accounts with an obligation to report these to Inland Revenue annually), subject to our below submissions on this proposal.

All references are to the Income Tax Act 2007 (the **Act**) unless otherwise stated.

II. Submissions

We submit on the following areas:

1. Dividend avoidance and share shares

1.1. Avoidance measure

(para 3.1)

Proposal

The Government is proposing to deem a "dividend" to arise where there is a sale of shares by a "controlling shareholder" to the extent that the company and its subsidiaries have undistributed retained earnings (excluding any non-taxable capital gains). The proposed deemed dividend amount on the sale of shares would be the higher of:

- the amount of retained earnings *less* non-taxable capital gains *plus* ICA balance; or
- the ICA balance divided by the company tax rate.

Comment

The Discussion Document intends to "[limit] the ability of individuals to avoid the top 39% rate…by diverting their income through entities taxed at a lower rate". We submit the proposal to deem a dividend to arise will not achieve this stated intention because it will impact taxpayers who are neither (1) avoiding tax nor (2) diverting income.

By way of example, the tax obligation for an individual under the proposed rules with $72 of retained earnings and $28 of imputation credits would be the higher of:
The individual's share of retained earnings plus the ICA balance (e.g. $72 + $28 = $100; or

- The individual's share of the ICA balance divided by the company tax rate (e.g. $28 / 28% - $100).

There is no requirement, in either of the above scenarios, that the taxpayer should be avoiding or diverting income for the proposal to apply.

While we appreciate that conceptually, the $72 of retained earnings may be viewed as business profits of the company and therefore can be argued as not being a "capital" amount, the reality is that retained earnings does not necessarily equate to the true economic position of the company - e.g where the amount has been reinvested into the business. It is not unreasonable to see this proposal as a limited form of capital gains tax in the absence of any avoidance concerns.

In our view, what is being proposed goes beyond an avoidance or integrity measure. Instead, it is a fundamental shift of New Zealand's tax system in that it looks to disregard the separate legal identity of companies and move towards full integration. In our view, Inland Revenue has the power to invoke section BG 1 of the Act where there is a tax avoidance arrangement (such as the case with example 1 in the Discussion Document).

Submission

That the proposals do not proceed and that the intended outcomes should be achieved by Inland Revenue's application of section BG 1.

1.2. Limitation to controlling shareholders will cause inequitable outcomes

(para 3.22)

Proposal

The Discussion Document states that the proposal to deem a dividend for retained earnings should be limited in application to a "controlling shareholder", being one that, together with its associates and other shareholders acting together, holds more than 50% of the shares.

Comment

The principle of horizontal equity is a key pillar of the New Zealand tax system (recently affirmed by the 2019 Tax Working Group's *Future of Tax: Final Report*). It is described as the principle that people who are in the same position should pay the same amount of tax.

One fundamental concern we have with the proposal is the lack of horizontal equity. This would manifest itself in two ways, between (1) "controlling shareholders" versus portfolio shareholders and listed companies and (2) controlling shareholders with different degrees of sophistication.

As to (1), the rationale is that it is the "controlling shareholders" who will have the ability to control whether a dividend is paid by the company or not. However, this does not alter the fact that a minority or portfolio shareholder would still benefit from the share sale if there is in fact an amount of the disposal price that represents undistributed business profits. In this case, two taxpayers in the same economic position are subject to different tax outcomes.

As to (2), we are concerned that the proposals would unduly affect small and medium sized businesses. While the proposals expressly apply to business of all sizes, in practice, smaller businesses will be affected more given the nature of the accounting treatment adopted by these businesses (which would impact the calculation of retained earnings) as well as the need for these businesses to reinvest funds into the business to grow (vs. having dividend paying policies which larger scale businesses may have). Sophisticated taxpayers are usually able to better navigate tax complexity and will likely find ways to release value from the business in a way which is not caught by the proposed deemed dividend rules.

Submission

That, if the Government proceeds with the proposal, further consideration should be given to how the proposal can be more horizontally equitable.

1.3. Deemed dividend limited to RE but does not extend to goodwill etc

(paras 3.30)

Proposal

The proposal to deem a dividend in respect of retained earnings would not apply to the capital receipt of goodwill created upon the sale of a company.

Comment

The retained earnings of a company does not represent the cash balance or economic income earned - it is an accounting concept. We submit that retained earnings is an inappropriate tax base for income tax as it does not necessarily reflect the true business profit which would be received by the shareholder.

An example of where the usefulness of retained earnings as a basis for tax is eroded include where the company has external funding and no capital gain. To illustrate:

Suppose a $1.5m commercial property was acquired in a company which is funded by:

- $1m of share capital (ASC)
- $0.5m bank loan

Opening balance sheet:

Assets		Liabilities / Equity		
Property	$1.5m	Bank loan		$0.5m
		Share capital	$1.0m	

Over the life of the company, the value of the property remains flat and the profits from rental activity are used to repay the bank loan.

Closing balance sheet:

Assets		Liabilities / Equity	
Property	$1.5m	Retained earnings	$0.5m
		Share capital	$1.0m

In this case, the taxpayer will be subject to tax on the $500k of retained earnings, even though there has been no overall increase in the value of the property, the taxpayer has not entered an avoidance arrangement, and no income has been diverted. This is caused by the use of external funding which has been repaid with retained earnings.

Another example of where the usefulness of retained earnings as a basis for tax is eroded is where a company has capital losses. This would be the case if the balance sheet were as follows:

Available subscribed capital	$1,000
Retained earnings	$720
Capital losses	($500)
Equity	$1,220

In this case, the taxpayer would be incentivised to liquidate the business rather than sell it, as the tax on retained earnings of $720 would be higher than the tax on the dividend on liquidation of $220 (subject to the ICA balance).

This illustrates why we consider the distinction between realised retained earnings and capitalised future earnings (i.e. goodwill) is unsupportable from an economic efficiency perspective. The proposals would penalise companies with more traditional earning patterns (which use retained earnings to fund growth) as compared to high-growth companies, which may be loss-making but valued highly due to their future earnings potential. A business investing heavily in research and development may have no profits but large unrecognised goodwill. The proposal would not impose a deeded dividend on this value. We understand that one justification for the proposal is that value received by an individual to be used for private consumption should ideally be taxed at the individual's marginal income tax rate, but that outcome is not achieved by the use of retained earnings as the basis for tax.

Similar to retained earnings, the amount of imputation credits that is held by a company may not reflect the true "undistributed" business profits. To deem a dividend to arise in these circumstances would result in overtaxation for those shareholders and arguably be imposing tax on a true capital gain.

Submission

That the Government does not proceed with the proposal. Further significant work is required to ensure any changes to the law does not result in unintended consequences, in particular the potential for overtaxation and that it is in fact consistent with policy intent (i.e. avoidance of the 39% tax rate).

1.4. "Acting together"

(paras 3.23)

Proposal

The proposal would apply if the shareholder controls the company immediately before the sale, together with associates and other shareholders acting together.

Comment

It is common for shareholders of companies to have entered shareholder agreements. These may apply to situations where a shareholder resolution is required to sell shares, or for decisions under a management share scheme.

There is a question as to whether shareholder agreements will cause all shareholders party to the agreement to be regarded as "acting together" such that minority shareholders would be treated as being a "controlling shareholder" under the proposal. Furthermore, whether this would bring in private equity type investors.

We note that one of the key areas of concern noted is the ability for a "controlling shareholder" to be able to control dividend payments and that it is mostly a concern for closely-held companies. The application of an "acting together" type approach could go beyond the issue that is outlined in the Discussion Document.

Submission

If the proposal is to proceed, the meaning of "acting together" should be given further consideration to ensure it does not go beyond the intended scope.

1.5. Operational issues

(Chapter 3)

Comment

We note a number of operational issues which could arise if legislation were enacted based on the current proposals:

- The calculation of retained earnings may be subject to variability because International Financial Reporting Standards (IFRS) and generally accepted accounting principles (GAAP) is not used, nor required to be applied, by most New Zealand companies.
- The calculation of retained earnings may be difficult when shares are sold mid-year (rather than at year-end, when equity balances are typically calculated). For New Zealand income tax purposes, additional guidance may be required as to how to calculate this amount on top of the existing accounting rules.
- There is a question as to how and when is the ICA balance should be measured for the purposes of the proposal.

Submission

That the operational issues noted above be addressed in the event the Government proceeds with the proposal.

2. ASC and ACDA tracking accounts

2.1. Tracking accounts

Proposal

Under current law, there is no explicit requirement for a company to maintain records in relation to its ASC or ACDA. At paras 5.4 to 5.10, the Discussion Document proposes two options:

1. ASC and ACDA accounts are to be maintained and reported to Inland Revenue annually.
2. ASC and ACDA accounts are to be maintained as evidence, with no requirement to report these to Inland Revenue annually.

Comment

We support the introduction of option 1. In our view, option 2 reflects current practice as taxpayers (and their advisors) will often carry out the ASC and ACDA calculations where they are being relied on for the purposes of sections CD 22 or CD 26. The issue with current practice is that taxpayers (and their advisors) must often rely on documentation that is either incomplete or missing (especially in relation to share issues on incorporation and historic capital gains derived).

Therefore, we consider the requirement to provide the information to Inland Revenue to be preferred on the basis that this will lead to better information in the future. However, we support option 1 provided that this requirement to report these accounts to Inland Revenue is on a prospective basis only.

We would also ask that any legislation address how the statute bar would affect historical filings and confirm that no penalties should be imposed for the failure to file returns.

Submission

That option 1 be adopted, subject to our comments above.

3. Personal services income attribution

3.1. Proposals go beyond the parameters of “Penny & Hooper”

Proposal

From para 6.9 onwards, the Discussion Document refers to *Penny & Hooper v Commissioner of Inland Revenue* [2011] NZSC 95 as a reason to support the proposals to widen the “personal services” attribution rules – i.e. codifying the decision from *Penny & Hooper* so that Inland Revenue does not have to rely on the general anti-avoidance rule where they feel there is mischief.

Comment

In our view, the current proposals go beyond the parameters of *Penny & Hooper*. It is important to note that in that case, tax avoidance was found whereby Penny & Hooper did in fact benefit from the funds personally (i.e. available for private consumption) even though they were paid an “artificially low” salary.

Under the current proposals, income that is legitimately left in the company to fund growth in working capital or investment in brand development and customer relationships will be attributed to the shareholders, even if there is no tax avoidance. That is, it would be possible to structure a business using corporate vehicles and pay oneself a market value salary and still be subject to the highest marginal tax rate on all income, rendering a company and a sole trader identical for tax purposes.

Submission

Should these changes be enacted, a requirement that the arrangement involves an “artificially low” salary be introduced also.

3.2. Horizontal equity concerns

Comment

Similar to our concerns with the share sale tax, we also have concerns of coherence and equity with these proposals as is the case with the deemed dividend proposals. In particular, we are unable to reconcile the fact that under these proposals, a services business will have a very different tax profile to one that produces and trades in goods. Under the current rules, we consider that the horizontal equity concerns are minimised due to the current “80 percent one buyer” and “80 percent one natural personal supplier” rules ensuring that the attribution rules only apply in limited circumstances where predominantly one individual is supplying services to predominantly one client.

Submission

The current “80 percent one buyer” and“80 percent one natural personal supplier” rules remain in place to limit the personal attribution rules affecting genuine services businesses.

If you have any questions relating to the submissions above, please do not hesitate to contact us.

Yours sincerely

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BCL

29th April 2022

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

Dividend integrity and personal services income attribution

Baucher Consulting Limited is a tax consulting firm founded in August 2004. It provides specialist tax advice to individuals, businesses in the SME sector and law and accounting firms needing advice on specific transactions. The company also has a public policy focus and as part of this regularly makes submissions on policy proposals and new legislation.

This submission has been prepared based on our discussions with Inland Revenue officials and our involvement with the preparation of the submission of the Accountants and Tax Agents Institute of New Zealand. ("ATAINZ"). We would like to thank Inland Revenue for the opportunity to engage in discussions on these proposals which we found informative and useful.

The views expressed here are those of Baucher Consulting Limited and are not a representation of any opinion or statement of ATAINZ.

The focus of our submission is on those parts of the proposals which we consider most affect our clients. It begins with some general commentary on the discussion document followed by our responses to the specific questions asked.

General commentary on proposals

We are concerned at the scope of the proposals in Parts I and III of the discussion document which we consider will fall disproportionately on small businesses which make up the majority of our clientele.

Although the discussion document suggested that attempts to circumvent the 33% rate are already occurring in our view it provided little evidence of the potential amount of tax involved. In particular, we have not seen sufficient evidence to support the need for the proposals outlined in Part III of the discussion document.

BCL

In relation to the proposals in Part I, these are driven by concerns regarding the excessive retention of earnings and imputation credits and the possible circumvention of a tax charge on distribution through the means of a sale of shares. As the discussion document notes the absence of a general capital gains tax means sales of shares are not generally taxed.

However, as we noted in our discussion with Inland Revenue officials, in the majority of cases in the SME sector in which I advise, a sale of business to a third party usually involves a sale of assets and not a sale of shares. In such circumstances, the recent purchase price allocation rules will apply to the sale and the vendors will then liquidate the trading company and be subject to the relevant rules regarding distributions at that point.

Against this background we consider a better alternative would be to introduce a limit on how long imputation credits may be retained without being distributed. For example, such a time limit could be ten years from the end of the imputation year in which the credit first arose. As discussed with officials, it would be reasonable to expect a company to have adopted some form of distribution policy within ten years of start-up. Under our suggestion, the imputation credits would expire if not distributed within the relevant period. Companies would therefore be incentivised to distribute retained earnings in order to ensure the benefit of imputation credits passes through to shareholders.

Advisors already pay close attention to imputation credit accounts so we consider introducing time limits should not significantly increase compliance costs for companies.

Although such a rule would have its own complexities, we consider it is preferable to the recharacterization approach proposed. In our view the recharacterization would be complicated to apply and would intervene excessively in commercial transactions carried out at arms' length.

We consider the proposed extension of the personal services income attribution rule in Part III of the discussion document goes too far. We would limit any potential extension to businesses with net income in excess of the $180,000 threshold above which the 39% tax rate applies.

We note that Figure 1 in the discussion document indicates that some self-employed taxpayers appear to be attempting to avoid higher tax-rates at the thresholds for the 30% and 33% rates ($48,000 and $70,000 respectively). Given recent inflation and that the current tax rates and thresholds have not been adjusted since 2010, we suggest that such taxpayers may be relying on excessive drawings to meet normal household expenditure.

If so, Inland Revenue already has existing tools such as applying the prescribed rate of interest to overdrawn shareholder/proprietor current accounts which it can use to counter perceived avoidance. It may, however, wish to consider treating the full amount of overdrawn current accounts as a dividend. We understand this is the approach in Australia and the United Kingdom.

In relation to employees acting as contractors, we consider Inland Revenue should deploy further resources into investigating whether "contractors" are in fact genuine contractors or de-facto employees. Reflecting on our experience as part of the Government's Small Business Council, we wonder whether tighter application of the existing law to deem contractors to be employees might help boost productivity within the SME sector. Furthermore, we consider the issue of defining contractors as employees might become more important if the Government's proposed Social Insurance Scheme is implemented.

We are concerned the personal services attribution proposals could mean owners of businesses in the same industry might be subject to very different tax treatment simply because of how one or two employees are utilised. We consider such an outcome would do little for the public perception of the integrity of the tax system.

Overall, although we accept the introduction of the 39% income tax rate requires integrity measures to ensure its broad application, we consider the proposals unfairly target the SME sector. Owner/operator companies, such as electricians, plumbers and other trades represent a significant proportion of small business enterprises. These proposals would complicate the compliance burden of such businesses.

Responses to specific questions

Part I

Question	Submission
Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?	Not in every circumstance

Question	Submission
Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?	Recharacterisation is appropriate in so far as it applies to related party transactions
Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?	On the basis that the proposals are effectively targeting undistributed income this basis is broadly acceptable.
What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two), and which of these approaches do you prefer? Is there an alternative approach you would suggest?	We are not sure either of the proposed methods adequately deal with issue of excess imputation credits relative to retained earnings because of losses incurred subsequent to when imputation credits arose. As noted in our introductory comments we consider a time bar limit on how long imputation credits may be retained without being distributed is our preferred approach.
Do you agree with the proposed approach (outlined in Example 3) for calculating dividends and ASC adjustments for corporate groups?	We consider the example illustrates the complexity of the proposals. We believe our suggestion for time-limited imputation credits may by-pass some of the complexity involved.
Is the approach outlined in Example 4 for a sale of one controlled company to another (existing) controlled company (potentially generating a deemed dividend from both companies) correct conceptually?	

Part II

Question	Submission
Whether the proposed transitional rule is appropriate.	Yes
Whether the Commissioner should be able to reopen a return and on what basis	Not for companies subject to transitional rule
Whether the proposal strikes an appropriate balance between compliance costs and tax integrity.	We consider the approach is reasonable. We think it likely much of this information is already being recorded permanently.
Whether the ASC and ACDA memorandum accounts should be reported in annual returns.	We recommend triennial reporting.

Part III

Question	Submission
Do you agree with the proposed removal of the "80 percent one buyer" test? Why/why not?	No, we are not convinced there is clear evidence of mischief which requires the change
Do you agree with the suggested decrease in the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?	No, as noted above we consider this an unnecessary expansion of the rule. We are also concerned it would introduce confusion for smaller businesses as to where the boundary arises.
Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?	We consider the suggested thresholds are too high and overstate the impact of inflation since 2000.

Question	Submission
Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter?	As noted above we consider the suggested thresholds are too high, and suggest it should be a maximum of $125,000.
Do you consider the net income threshold should be increased from $70,000 per year to $180,000?	Yes, aligning with the threshold at which the 39% commences seems appropriate. Would also minimise the compliance burden for SMEs

We would be pleased to discuss any part of our submission with officials.

Yours faithfully
BAUCHER CONSULTING LIMITED
s 9(2)(a)
[redacted]

Terry Baucher PTBA
Director

Submission to Government Discussion Document

Dividend integrity and personal services income attribution

Submission submitted by Howard Severinsen

Date 29 April 2022

My submission relates to the above.

1 The information published invites submissions. It states that….

Consultation on top tax rate avoidance prevention proposals

The Government is seeking feedback on measures that would limit the ability of individuals to avoid the 39% or the 33% personal income tax rates by using a company structure.

For more information on the proposals, and how to make a submission, see the Government consultation document ***Dividend integrity and personal services income attribution***.

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

Despite these claims and many website/link searches and blind alleys, there seems to be no mention of how submissions should be made. So we are not off to a good start.

2 The whole tone of the document is about taxpayers re-arranging their affairs in order to avoid the new, 39% top tax bracket. It contains no analysis of how it might affect businesses legitimately going about their business prior to the introduction of the 39% bracket. New Zealand is said to be a nation of small businesses. This omission is a serious omission in my opinion. At the very least there should be an analysis of unintended consequences of the proposed changes to the proposal. It also suggests a deeper failing with the introduction of the 39% tax bracket and any consequential affects. Why weren't these thought of earlier?

3 The consultation document and its tone throughout suggests to me that most small businesses have full knowledge of what the future holds for them. And that they arrange their affairs with that full knowledge. I submit that in many cases this will not be the case. Take the electrician with a van and tools for example. Does she know how many clients she is likely to have in the forthcoming financial year? Will it continue to be many small clients, or will she perhaps win that bigger job for the retirement village that she has been chasing? I submit that the proposed changes to the attribution rules will cause her to seriously consider closing down her nascent business and just taking a job with the bigger company down the road. This doesn't feel like a more efficient outcome to New Zealand to me. Surely we want to encourage people to take on business ventures.

4 Support for the 39% rate. The consultation document states its ambition/purpose to support the integrity of the 39% rate.

> from its original purpose of capturing employment like situations to instead apply more broadly to help to support the integrity of the 39% personal tax rate. This is because there is some concern that the rule in its current form may

Yet inexplicably there is no intention to change the $70,000 threshold to $180,000! If this wasn't actually very important this would be laughable. The purpose of the proposals should be more honestly restated if the $70,000 threshold is to be retained. You choose the language. Perhaps this is the deliberate matter to be later conceded, to show that consultation was meaningful.

5 The document indicates a degree of pre-determination and power on the behalf of an individual. See one extract below (and similar tone in many other places).

> 6.3 The combination of these tests targets the rule at individuals who, using an interposed entity, sell their labour to a buyer in the specific situation where these individuals would likely have traditionally supplied their labour as employees, rather than as independent contractors.

I submit that reality is quite different. There are two parties to any employment/business arrangement – employee/supplier and employer/client. The client needs any contractual arrangements to ''work" from their point of view too. Suppliers don't have carte blanche to impose their chosen structures. Clients are often careful to avoid creating any form of an employment agreement. The document is out of touch with the dynamic in this area.

6 The examples given are pitiful. How many clients does Bill's company have? How was Bill's company revenue distributed amongst those clients? Is he now deemed to be an employee of each of his clients in terms of the Employment Relations Act 2000? What is the before and after situation for Bill?

7 Good tax policy should be fair. I submit that the propped changes are not fair. They discriminate (quite viscously) on scale. Take the example of Bill. What if ten individual Bills join together? The new entity – TentimesBill – will presumably pass both the 80% rules and the business assets rule. Purely because of scale. Larger businesses have more clients/customers – smaller ones have fewer. I submit that the proposed measures as described are not fair. It would penalise micro sized businesses, purely due to the scale of their operations. And New Zealand has many, many micro sized businesses. The proposed changes would drive many of them out of existence.

8 Good tax policy should be efficient – both in terms of compliance and collection and any business changes or arrangements caused by them. I submit that the proposed changes would lead to significant manoeuvring to make arrangements in accordance with the market signals received. Changing many "A Plus Accounting Ltd"s into "TentimesBill"s wouldn't be efficient. The accounting and legal costs would be high and ultimate borne by the eventual clients.

9 I submit that the most relevant finding in the quoted case of Penny & Hooper was in fact the use (or misuse actually) of artificially low salaries. The proposed changes outlined in the consultation document seem like a sledgehammer to crack a walnut. Surely there must be an easier way to tackle use of artificially low salaries rather than the changes proposed? I note that Penny & Hooper used a trust to avoid tax. As trusts are tased at 33% anyway, I wonder whether this practice is very common in 2022? An individual needs to earn about $332,000 to be paying overall tax of 33% on their total income. There would be a rather narrow band of individuals that this applies to. Perhaps there is not much tax leakage via trusts?

10 The changes as described appear to discriminate against the provision of services as opposed to the provision of goods. This doesn't seem to be fair.

11 if the proposals continue in any form there should be a phase in period. This would allow those adversely affected time to consider their business prospects and either make adjustments in a planned manner or close down those businesses affected.

Please include me in any further consultation on this matter.

Prepared by Howard Severinsen

s 9(2)(a)

End of submission.

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29 April 2022

Dividend integrity and personal services income attribution
C/- Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
P O Box 2198
Wellington 6140
Email: policy.webmaster@ird.govt.nz

Dear Sir / Madam

Dividend integrity and person service income attribution

Thank you for the opportunity to make a submission in relation to the abovenamed Government discussion document.

In summary

- We disagree with the proposed dividend integrity measures and changes to the person service income attribution rule.

  We are supportive of proposed measures in relation to ASC and ACDA, although we recommend that ASC and ACDA returns be subject to the same time-bar that applies to the income return with which they are filed.

The reasons for are views are set out in the attached submission.

Should you have any questions in relation to this submission, please contact the writer.

Yours sincerely
Findex NZ Limited

s 9(2)(a)

Stephen Richards
Partner – Tax Advisory
Email: s 9(2)(a)

The title 'Partner' conveys that the person is a senior member within their respective division, and is among the group of persons who hold an equity interest (shareholder) in its parent entity, Findex Group Limited. The only professional service offering which is conducted by a partnership is external audit, conducted via the Crowe Australasia external audit division and Unison SMSF Audit. All other professional services offered by Findex Group Limited are conducted by a privately owned organisation and/or its subsidiaries.

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SUBMISSION - DIVIDEND INTEGRITY AND PERSONAL SERVICES INCOME ATTRIBUTION

A Government discussion document

PART I – SALE OF SHARES

General Comments

1. We consider the proposals go beyond preventing individuals avoiding tax or diverting income to lower tax-rate entities and have the potential to over tax shareholders undertaking neither of these activities. Further, these proposals will impose additional compliance costs on businesses required to comply.

2. As noted in the discussion document the proceeds of selling shares held on capital account are treated by our tax system as a non-taxable capital receipt. These proposals effectively represent a capital gains tax on share sales.

3. The proposal represents a tax on a transaction and as such will interfere with everyday transactions and cause economic distortion. There seems to be an underlying presumption that if a shareholder sells their shares in a company their motivation is to avoid paying tax on retained earnings. The reality is very few share sales are motivated by such a purpose and those that are will fall foul of existing avoidance rules.

4. A further underlying presumption seems to be that businesses are conducted through companies to avoid income being taxed at individual tax rates. As noted in the discussion documents there are many good reasons for trading through a company that nothing to do with tax. While some professional people may use companies to engage with their employer (for which we have attribution rules), for most people the selection of a company as a trading entity will be driven by commercial considerations: not a desire to avoid the top personal tax rate.

5. There also seems to be a presumption that earnings are retained in a company solely to avoid paying tax at the top personal tax rate. This overlooks the commercial reality that many entities retain funds to finance the company's growth rather than as a source of funds to spend on shareholders.

6. The statutory definition of "tax avoidance" effectively means that every transaction that effects a person's income is tax avoidance. Therefore, the definition of tax avoidance arrangement requires the tax avoidance purpose or effect to be more than incidental. This is an element that is missing from both this proposal and that relating to the personal services income attribution rule. Circumstances and transactions have been identified that can be construed as "tax avoidance" (any transaction that impacts income is), but no regard is had for whether that tax avoidance effect is merely incidental. In a minority cases it will not be, but in the vast majority it will not be. To stop the minority, normal business transactions are interfered with and additional compliance costs imposed on businesses, particularly SMEs.

7. Underscoring our concerns is the distinct lack of consultation (generic tax policy process) on these matters before the discussion document was published. Our firm has no issue with Government wanting to ensure personal services income is taxed at the appropriate personal marginal tax rate – but the proposals in this document go well beyond that. Earlier

consultation would have improved the proposals, provided better focus for submitters and better outcomes for Government.

Chapter 3 – Questions for Submitters

Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?

8. No: this represents a fundamental change to our tax law It shifts the focus from the transaction at hand, the sale of shares, to a piercing of the corporate veil to attribute the company's realised earnings to the selling shareholder. While officials may believe moving our company tax base to a more integrated model is desirable for personal services income, attempting to do this for all businesses under the guise of dividend integrity is very disappointing.

9. The proposal focuses solely on the retained earnings and imputation credit account of the company and has no regard to what creates the value that the shareholder is realising on the sale.

10. For example, consider the situation where a company is formed with a $100 of share capital and a $100 loan from the bank to fund the acquisition of $200 of capital assets. The company trades successfully and uses retained earnings to repay the bank loan. The shareholder has increased their shareholder funds (capital) from $100 to $200 by repaying debt funding. The company still has $200 of capital assets, but now funded by $100 share capital and $100 retained earnings. There has been no diversion or avoidance of tax. The income has been earned by the company and it has paid tax on it. The retained earnings are not available for distribution to the shareholder as they are required to fund the company's assets, but under this proposal the shareholder will be required to pay tax on the retained earnings on the sale of their shares.

Should the scope of the proposed recharacterisation rule cover all of scenarios A, B, or C, or only one or two of these scenarios?

11. Example 1 is presented as justifying the inclusion of Scenario A (no change in economic ownership) in the proposed rule. The example represents a dividend strip that would fall foul of the existing dividend stripping rule. This transaction has a clear tax avoidance purpose.

12. However, we fail to see how Example 1 justifies the application of an anti-avoidance dividend stripping rule to all share transactions that do not involve a change in economic ownership. This example relies on the sale of all the shares in Bullseye to Purchaser to obtain the advantage of the inter-corporate tax exemption. The proposed rule would apply to any sale of shares in Bullseye to Purchaser, yet a sale of less than 100% does not obtain the tax advantage claimed to justify the proposed transactions.

13. Any transaction whereby Shareholder sold less than 100% of the shares in Bullseye to Purchaser that was followed by a dividend by Bullseye used to clear Purchaser's debt to Shareholder would in our view full foul of the existing anti-avoidance rules.

14. There are many commercial reasons why a corporate group may wish to restructure ownership of group members. For example, to rationalise group structure, to bring

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companies trading in similar businesses or areas within a subgroup, to the position part of the group for sale, or to facilitate an amalgamation. These transactions are not motivated by tax avoidance, but commercial imperatives. Extension of dividend stripping rules to these types of transactions imposes a tax cost on normal commercial restructurings. These companies are not retaining earnings to avoid taxation, but to fund ongoing business operation.

15. Example 2 is presented as justification for including Scenario B (sale to an unrelated company) in the proposed rule. Again, this example is the sale of 100% of Bullseye's shares to Purchases and relies on the inter-corporate tax exemption to obtain a tax benefit and arguably could be attacked as avoidance.

16. We do not consider that this example provides justification for extension of dividend stripping rules to every sale of shares to an unrelated company. Where the share sale will result in a breach of shareholder continuity (any purchase of over 34% of the company, but less than 100%) a dividend will be paid before the shareholding change. The purchaser does not want to acquire a company with reserves that are not covered by imputation credits nor do existing shareholders want to receive unimputed dividends in the future.

17. As stated earlier there is the presumption that the sell down of shares is motivated by a tax avoidance purpose. The reality is that the reasons why a shareholder will sell down their shareholding in a company are many and varied. For example, as part of a succession plan or to introduce employees as shareholders. Selling down shares in a profitable business, with the consequent dilution of ownership interest, to avoid paying tax on retained earnings will be toward the very bottom of the list of reasons. Yet this proposal will impose tax on and interfere with many transactions that have nothing to do with avoiding tax.

18. Example 3 is presented as justification for including Scenario C (sale to unrelated individual) in the proposed rule. This example is not commercially realistic. A purchaser in this case would discount the purchase price to recognise they were acquiring a company without imputation cover for its retained earnings or require the company to declare a dividend before acquiring the company. We fail to see how this justifies the extension of dividend stripping to sales of shares to unrelated individuals. At best there is a deferral of tax, if no dividend is declared, but this is only the case if the company would have paid a dividend had the share sale not occurred and there is no requirement on the company to do so.

19. As noted above there are many reasons why a shareholder will sell down their shareholding in a company. Selling down shares in a profitable business, with the consequent dilution of ownership, to avoid paying tax on retained earnings will be toward the very bottom of the list. Again, this proposal will impose a tax cost on and interfere with many transactions that have nothing to do with avoiding tax.

20. We consider this proposal represents a significant change to our tax system whereby the earnings of a company are effectively being attributed to its shareholders. Legally, these earnings are those of the company until the company elects to distribute them to its shareholders. If shareholders wish to pay tax on company income, they have the option of electing for the company to become a look-through company.

21. However, as above, if the Government's desire is to move to a more integrated model for the taxation of companies that is a policy decision for Government; but this should not be undertaken as part of an exercise that is addressing the issue of the taxation of personal services income.

Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?

22. We oppose these proposals in their entirety. However, we consider the 50% threshold to be arbitrary. The examples used to justify the inclusion of Scenario A and Scenario B require a disposal of 100% of the shares to obtain the avoidance of tax on the distributions. As discussed above these benefits do not arise when a lesser level of shareholding is involved and therefore, provide no justification for applying the proposed rule to a sale of anything less than a 100% of the shares.

23. The setting of the threshold creates the perverse position where a 49% shareholding in a company will provide a shareholder with a better return than the 50% shareholding. In that the 49% shareholder can exit the company without incurring a tax impost, whereas any reduction in the 50% shareholding will incur a tax impost.

24. We note that the rationale for 50% appears to be that 50% gives control of the company and the ability to influence dividend policy. It cannot be assumed that associated persons owning 50% or more of the shares collectively means they control a company. Family members disagree about the direction of the company and their different circumstances may they have different views of the company's dividend policy. It should not be assumed that associated family members will all vote the same way.

Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?

25. Undistributed income does not necessarily represent the funds available for distribution to shareholders. The existence of capital losses may mean retained earnings are not available for distribution. The discussion document dismisses making allowances for capital losses on the basis it is effectively allowing a deduction for a capital loss. The oversimplifies and misunderstands the position.

26. To make a distribution a company must satisfy the solvency test. The existence of capital losses will impact a company's solvency meaning a company may be unable to distribute its retained earnings due to the impact of capital losses on solvency. Under this rule an exiting shareholder would potentially pay tax on retained earnings the company had no ability to distribute. In this situation there is no avoidance of tax on those retained earnings as they were not distributable in normal circumstances.

27. Consider a company with $10,000 of share capital, $7,200 of retained earnings and a capital loss of $8,000. The shareholder's funds are $9,200 representing a capital loss of $800. If the shareholder elected to liquidate the company, the shareholder would receive a $9,200 tax-free return of share capital. However, if the shareholder choose to sell the company for $9,200, under this proposal the shareholder would be treated as receiving a $9,200 taxable dividend ($7,200 retained earnings grossed up to a $10,000 with the addition of imputation credits and then reduced to the sale price of $9,200).

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28. Further retained earnings may include revaluation of revenue account property, this is unrealised income with tax payable in the future. For example, consider a property development entity that has revalued its development land by $1,000,000. The net of tax value of $720,000 is carried in to retained earnings and provision is made for the future tax liability of $280,000. Currently, there is no tax payable because the property has not been sold. However, under this proposal an exiting shareholder would pay tax on this amount without the benefit of imputation credits. Later when the company sells the land it will pay tax on the land sale resulting in double taxation.

29. Therefore, the tax outcome for a shareholder could depend on whether a company is required to revalue revenue account property, chooses to (for example to satisfy banking covenants) or has the option to value at tax book value or cost.

What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two), and which of these approaches do you prefer? Is there an alternative approach you would suggest?

30. Both approaches have no regard to actual amounts available for distribution. The liquidation approach is rejected as being too complex. However, we consider both the proposed alternatives involve significant complexity.

31. A critical issue that arises is when are retained earnings to be determined? This should be at the date of the share transfer if the intention is to ensure a shareholder pays tax on company earnings derived while the person is a shareholder. This is fine where a sale occurs at balance date and may also work where there is a significant shareholding change and settlement accounts are prepared. However, in other circumstances where minor share sales occur, financial statements would not normally be prepared. The need to determine retained earnings for the purposes of the proposed rules will incur additional compliance costs for what could be a minor shareholding change. This would act as a barrier to majority shareholders transferring minor shareholdings to the likes of employees or family members wanting to join the business.

32. Providing for retained earnings to be determined at the balance date prior to the transaction or after the transaction is simply shifting the tax liability of the vendor to the purchaser or vice versa.

33. This approach has the potential to tax scenarios where the shareholder has not derived any gain. Consider the situation where a company is formed with a $100 of share capital and a $100 loan from the bank to fund the acquisition of $200 of capital assets. The company trades successfully and uses retained earnings to repay the bank loan. The shareholder has increased their shareholder funds (capital) from $100 to $200 by repaying debt funding. The company still has $200 of capital assets, but now funded by $100 share capital and $100 retained earnings. The present shareholder purchased the company for $200 from the original shareholder and has paid all income derived during their ownership either a dividend or shareholder-employee salary. They are now selling the company for $200 represented by the $100 of share capital and $100 of retained earnings that existed when they acquired the company. Under this proposal, they will pay tax on the $100 of retained earnings that existed in the company when they acquired it despite having paid tax on all income while they were a shareholder and not making any gain on the sale.

34. The use of grossed up ICA creates potential over taxation. As noted above, to make a distribution a company must satisfy the solvency test. Reference to ICA balance has no regard to the company's ability to pay a dividend.

35. We disagree with the suggestion that the dividend on sale should be the greater of that determined under the retained earnings approach and the gross up of the ICA balance.

36. We consider that, if a dividend is to occur on the sale of shares, that dividend should be capped at the amount of the retained earnings. A company is limited to the amount of its retained earnings when paying a dividend. If a company pays a dividend more than its retained earnings it is distributing either capital reserves or share capital. Therefore, as a rule a company will avoid doing this as it is converting non-taxable amounts to taxable amounts. By calculating a sale dividend based on the ICA balance, the exiting shareholder is being overtaxed. Where the dividend able to be fully imputed by the ICA balance exceeds the retained earnings, there are no retained earnings on which tax is being "avoided".

37. A further issue that arises is when is the ICA balance to be determined and what adjustments are to be made? For example, assume a share sale on 31 March 2022. The ICA balance at 31 March 2022, will not include imputation credits that arise from the final provisional tax instalment for the year (due 7 May 2022) or any terminal tax payment for 2022 (not due until 7 February 2023 or 7 April 2023). An exiting shareholder will at that date be attributed the company retained earnings for the 2022 year, but a third or more of the company's tax will not have been paid. The deemed dividend to the exiting shareholder will not be fully imputed resulting in double taxation of the income. The company will then pay tax on the income, which has now become ASC, resulting in a ICA overhang next time a controlling shareholder exits and further tax will be payable on what is effectively income attributed to the shareholder that exited on 31 March 2022, but is taxed again due to the ICA gross up. Therefore, one amount of income is effectively taxed three times, once in the original exiting shareholders name due to a lack of imputation credits, then in the company's, and then in the hands of a later exiting shareholders hands due to the ICA overhang created by the original share disposal.

38. The example assumes a sale at balance date, but how will this work when the sale occurs during an income year when the timing of tax payments will affect the dividend attributed to an exiting shareholder.

39. A further consideration is the impact of refunds. The balance of an ICA may be overstated due to a refund that has not been received. If the ICAs are deemed attached to a dividend paid to an exiting shareholder, this may prevent a company receiving a refund that it is owed.

40. Under the current system where the final provisional tax payment occurs after the end of the income year and the final tax payment may be more than 12 months later, the ICA balance may only reflect the retained earnings position more than 12 months after balance date. This creates the potential for significant over taxation and double taxation.

41. A significant overhaul of the imputation regime and the ability to accrue future tax payments and refunds to determine the ICA balance at the time of a share sale to prevent over taxation will be required.

42. The approach of grossing up the ICA will also result in over taxation where a company has moved from a profit-making position to a loss-making position or vice versa. Consider a company with $1,000 of share capital. It trades successfully for several years accumulating retained earnings of $720 and $280 of imputation credits. Over the next few years, it suffers losses of $720 leaving it with no retained earnings. The shareholder sells the business for $1,000 being the amount of its share capital. However, due to the existence of $280 of imputation credits the $1,000 sale prices becomes a taxable dividend to the shareholder. Had the shareholder decided to liquidate the company, the $1,000 would have been a non-taxable distribution on liquidation.

Do you agree with the proposed approach (outlined in Example 6) for calculating dividends and ASC adjustments for corporate groups?

43. We note that corporate group for this purpose is defined as 50% common ownership. This is below the normal 67% for a group of companies. While 50% is consistent with the ownership level for the proposal to apply, there is the potential for confusion if a different grouping threshold applies than normally applies for income tax.

44. The process of consolidating the retained earnings and ICAs of each individual company has the potential to compound all the issues identified above and lead to significant over taxation of the shareholder and potential double taxation. For the reasons outline above we do not consider that simply adding up ICA balances will provide the correct result.

Is the approach outlined in Example 7 for a sale of one controlled company to another (existing) controlled company (potentially generating a deemed dividend from both companies) correct conceptually?

45. We disagree with this proposal.

46. This is an over complication. The starting position for this proposal was a shareholder selling shares in a company with retained earnings to another wholly owned company should result in the shareholder deriving a dividend from the target company. The justification being that the some of the consideration received is in lieu of the dividend the shareholder could have received from the target company.

47. This further proposal makes the leap that the purchasing company, by purchasing the target company, is making a distribution of its retained earnings to the shareholder. Therefore, the dividend in the first instance should be from the purchasing company and only from the target company if the purchase price exceeds the dividend deemed from the purchaser.

48. While we disagree with the rationale behind the dividend integrity proposal, if there is a belief that shareholders are selling share in a company to avoid receiving a dividend from it then surely the dividend should come from the company they are selling not the one that is acquiring it.

49. Alternatively, if the view is that the transaction is undertaken not to avoid a dividend from the target company but to access the retained earnings of the purchaser without receiving a dividend, why restrict this rule to share purchases. By this rationale every time a shareholder sells a capital asset to a company can be viewed as the shareholder accessing the retained earnings of the company without receiving a taxable dividend.

50. For example, consider an individual selling a company that owns a piece of land held on capital account worth $2 million to another company the individual owns. Depending on the retained earnings level and ICA balance of the purchasing company some or all the $2 million would be a taxable dividend to the shareholder. Alternatively, if the land was sold from one company to the other it would be a $2 million capital receipt to the first company. That company could then be wound up and the funds distributed to the shareholder potentially on a non-taxable basis as ASC and ACDA depending on how the land was funded (assuming the land is not still 85% commonly owned at the time of liquidation, which it will not be, for example, if the purchasing company has developed and sold it). The alternative provides the correct tax outcome, the proposed rule the incorrect outcome.

51. Further why should the tax outcome be different for the shareholder that sells a company owning land worth $2 million to the purchasing company and a shareholder who sells the land to the company. Under this proposal the former results in the shareholder potentially deriving a $2 million taxable dividend. The latter a $2 million capital receipt.

52. Again, there is a presumption of a tax avoidance purpose for a transaction that may be undertaken for valid commercial reasons. As a tax on transactions this proposal will interfere with everyday transactions and cause economic distortion through imposing artificial tax outcomes.

53. As discussed above the determination of the dividend amount from the purchasing company and potentially also the target company is fraught with issues.

PART II ASC AND ACDA TRACKING ACCOUNTS

General Comments

55. We agree that ASC and ACDA are for many companies poorly tracked over their life and considerable time can be spent trying to establish these amounts for the purpose of a share repurchase or liquidation distribution.

56. However, many SMEs have minimal ASC that does not vary over the life of the company. The tracking of ASC is more problematic when dealing with larger companies that have been involved with multiple transactions over an extended period. This can be a time-consuming process and lead to some uncertainty as to the correctness of the ASC amount and robustness of supporting evidence. While best practice would suggest tracking ASC is desirable, this is often not done.

57. We are supportive of a requirement to track ASC. This is unlikely to impose significant compliance costs on SMEs and timely tracking will be beneficial to companies involved in more complex business transactions.

58. For many SMEs a lack of understanding of what comprises ACDA means it is rightly or wrongly assumed that the capital reserve accumulated for accounting purposes is its ACDA. Even for larger companies, a liquidation requires a review of the make up of accounting capital reserves to determine the ACDA.

59. We are supportive of a requirement to track ACDA. For SMEs we do not foresee this as being an onerous requirement and for larger companies will provide long run benefits.

60. We consider that a benefit from a requirement to track ASC and ACDA will be to provide greater certainty to companies undertaking share purchases and liquidations that they have correctly identified these amounts.

61. However, we consider the proposal does not provide as much benefit to taxpayers as it could by proposing no limit be placed on the Commissioner’s ability to challenge a return in relation to the ASC or ACDA memorandum accounts. We disagree with this.

62. We consider annual ASC and ACDA returns should be subject to the same time-bar as the income tax return with which they are filed. This will provide greater certainty to companies undertaking share repurchases and liquidations as to their ASC and ACDA balances. They would then only need to be concerned with the potential challenge to transactions within the last four years rather than being concerned with having evidence to substantiate transactions that may have occurred many years earlier.

63. One of the primary difficulties with ASC and ACDA for long-standing companies is that companies need to have records of transactions that occurred ten, twenty, thirty or more years ago. Not only are they required to keep these records, but they may also need to understand how that transaction was treated under tax law at the time or need to re-examine the transactions treatment in light of current legislation. This can create significant uncertainty as to the actual level of ASC and ACDA with the onus on the company to prove the correctness of those balances.

64. The ability to disclose transactions impacting ASC and ACDA on an annual basis and have the treatment of the disclose transactions placed beyond challenge after four years will

greatly reduce the compliance costs faced by companies and decrease the uncertainty around the correctness of the balances.

Chapter 5 – Questions for Submitters

Whether the proposed transitional rule is appropriate.

65. We agree that the proposal should only apply prospectively.

66. However, we suggest that consideration should be given to introducing a process by which retrospective approval of ASC and ACDA balances existing at the date these rules come into force. Some companies, particularly those that have existed for some time or been involved in complex transactions, may see value in having the Commissioner approve their starting ASC and ACDA balance especially if a time-bar was available.

Whether the Commissioner should be able to reopen a return and on what basis.

67. As discussed above, we consider that ASC and ACDA returns should be subject to the same time-bar as the income tax return with which they are filed.

Whether the proposal strikes an appropriate balance between compliance costs and tax integrity.

68. We have discussed this in our general comments above.

69. We consider the balance between compliance costs and tax integrity would be improved if companies were to obtain the benefit of the certainty provided by a time-bar on ASC and ACDA returns.

Whether the ASC and ACDA memorandum accounts should be reported in annual returns.

70. We are supported of the ASC and ACDA memorandum accounts being reported as part of the annual return and considered they should gain the benefit of the time-bar applying to that return.

PART III PERSONAL SERVICE INCOME ATTRIBUTION

General Comments

71. We disagree with these proposals.

72. The personal services income attribution rule was designed specifically to counter individuals contracting through a company to provide their services in substitution for entering an employment relationship with the intention of avoiding the top personal tax rate. It achieves this objective. The discussion document suggests this rule is too easy to structure around by providing services to multiple buyers. This is not an example of the rule being structured around, but of a scenario that the rule was not intended to cover. The rule is narrowly targeted to capture arrangements that involved contracting through an interposed entity in substitution for entering an employer-employee relationship to avoid tax.

73. The *Penny & Hooper* case involved taxpayers restructuring their affairs to reduce the income derived in their personal names and thereby reduce the tax payable on that income. Key features of that case were a restructuring due to a change in tax rates and the taxpayers continuing to enjoy an unchanged level of income, through income being channelled through trusts, but without incurring the higher level of taxation.

74. We consider that this proposal amounts to a significant change to the basis on which entities in New Zealand are taxed. The personal services income attribution rule was designed to combat a specific avoidance arrangement. *Penny & Hooper* dealt with taxpayers arranging their affairs to avoid tax.

75. This proposal, as with the dividend integrity rules, seems to be predicated on the basis that trading through a company is tax avoidance. This represents a significant shift in tax policy.

76. If there are concerns with individuals artificially suppressing their income, we do not consider that the income attribution rule is the appropriate tool for doing this. It was designed for a situation where there was little commercial justification for trading through a company and the "business" was really an employer-employee relationship. Attributing all company income in these circumstances is appropriate as the company's income would otherwise be the working person's salary.

77. This is different from an individual or individuals conducting a business through a company and providing services to a range of clients. There are genuine commercial reasons for trading through a company and genuine commercial reasons for retaining income within the business. The application of the income attribution rule ignores those reasons. At the same time, we acknowledge that if the reasons for retaining income are tax motivated a mechanism is required to counteract that. However, we do not consider the income attribution rule and proposed modifications are the appropriate mechanism

Chapter 7 Question for Submitters

Do you agree with the proposed removal of the "80 percent one buyer" test? Why/why not?

78. No.

79. This change significantly alters the scope of this rule from being targeted at a specific tax avoidance arrangement to treating the use of a company as a tax avoidance arrangement. The 80% threshold exists to prevent structuring out of the rule by adding a secondary minor source of income.

80. Example 8 is used as a justification for this rule. It involves Bill being paid $70,000 and the balance of the income being left in the company or made available as loans to Bill. If the surplus funds are left in the company then Bill does not have use of the funds. However, this change is suggesting that despite the company utilising the funds and Bill not having access to it, he should nonetheless pay tax on it. Alternatively, if the funds are loaned out to Bill, he will be incurring interest on the loan or if no interest is charged deriving a taxable dividend. Bill would be incurring 4.5% interest, which is taxable to the company, to save paying an extra 5% tax. While a small benefit may accrue in the short run any benefit will be eroded through interest charges and increased tax payable by the company. At some point, Bill will need to repay the funds (which will be difficult if used to finance his lifestyle) or a dividend will need to be declared to clear the overdrawn current account meaning Bill pays the additional tax on the income. Overall, this scenario results in more tax being paid due to the interest charge on the loans and there is no tax avoidance.

81. Further if Bill is paying himself a $70,000 salary while enjoying a $150,000 lifestyle through borrowing surplus income from the company, there would seem to be clear grounds for challenging this as a tax avoidance arrangement. This was one of the issues addressed in Penny & Hooper.

82. As noted above, this proposal means the rule goes from targeting a specific avoidance arrangement to deeming a decision to trade through a company to be tax avoidance. There are many reasons why an individual may choose to trade through a company, concerns about personal liability and the limited liability afforded by a company is a primary one.

83. An individual trading through a company wants to enjoy the fruits of their labour, the company is there for commercial reasons not to avoid tax. Very few individuals will choose a $70,000 lifestyle rather than a $150,000 lifestyle to avoid paying tax. No evidence has been provided to show that this is a real issue.

84. Further as was noted in *Penny & Hooper* there are legitimate reasons why an individual may choose to elect to retain funds in a company, such as funding future expansion or saving for replacement or upgraded equipment. The attribution of income to the individual, when there is a genuine reason for retaining some earnings in the company becomes problematic as the company will accumulate retained earnings on which no tax is paid. The existing rule allows for deemed imputation credits and elections to be treated as a qualifying company with respect to certain distributions, but still leaves open the potential for double taxation and adds additional compliance costs to anyone trading through a company for valid commercial reasons. We are also concerned with how this will interact with the proposal for share sales to give rise to dividends and the potential for double

taxation to arise where income has been retained in a company, but attributed to the working person for tax purposes.

85. This proposal will also result in different tax outcomes for taxpayers depending on the type of business they choose to pursue. An individual trading through a company to provide personal services to a wide range of customers will be subject to attribution. An individual trading through a company utilising significant assets will not be. An individual that elects to undertake a retail business through a company will not be.

Do you agree with the suggested decrease in the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?

86. No.

87. Again, this significantly alters the scope of the rule from targeting arrangements substituted for employment relationships to targeting trading through a company as tax avoidance.

88. If the policy rationale is that this rule is the need to prevent an individual avoiding tax on income arising from their personal exertion, then this threshold should be set at a high level. An argument could be made that 80% is too low. Dropping the threshold to 50% means the individual is being attribute a sizeable portion of income that does not arise from their personal exertion. This seems contrary to the justification for the rule.

89. This also seems to create an arbitrary distinction where one or two individuals providing personal services through a company is subject to attribution, but three individuals providing the same services through a company are not. Penny and Hooper may be caught if they practice together through a company, but if they add a third orthopaedic surgeon to the company they are not.

Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?

90. The thresholds suggested are arbitrary with no basis provided for them.

91. We support keeping this threshold as low as possible. It is preferable that this proposal disrupts the business activities of as few as taxpayers as possible and, accordingly, support a low substantial asset threshold.

92. We disagree with the exclusion of motor vehicles from the asset calculation. While it may be true that in some cases, they are not integral to the work performed, that will not be the case in every situation. In some cases, a vehicle may be retained exclusively or nearly exclusively for business purposes.

93. Accordingly, we do not consider vehicles should be excluded. Alternatively, their value for these purposes could be reduced for non-business use. For example, only half the value of a vehicle used 50% of the time for busines would be included in the calculation of substantial business assets.

Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter?

94. For the reasons, stated above we prefer the second option which provides for a lower threshold.

Do you consider the net income threshold should be increased from $70,000 per year to $180,000?

95. As discussed, we disagree with this proposal. If it is to be enacted, it is preferable that it disrupts the business activities of as few as taxpayers as possible and, accordingly, endorse increasing the net income threshold to $180,000.

This is consistent with the original intent of the rule of preventing avoidance of the top personal tax rate.

29 April 2022

Deputy Commissioner

Policy and Regulatory Stewardship

Inland Revenue Department

PO Box 2198

Wellington 6140

Dividend integrity and personal services income attribution

Introduction

I make some high-level points on this discussion document. I make this in my personal capacity.

Proposals

The discussion document proposes:

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.

2 That companies be required, on a prospective basis, to maintain a record of their available subscribed capital and net capital gains, so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation.

3 That the "80 percent one buyer" test for the personal services attribution rule be removed.

Submission

General policy

From a general policy position I agree that income derived from personal services should be taxed to the person that performed the services at their personal marginal tax rate.

As Tax Director of the then New Zealand Institute of Chartered Accountants when the decision in Penny and Hooper was released we responded to this by working with Inland Revenue to educate practitioners on the implications of the Supreme Court decision. This involved a country-wide road show with senior IR legal staff. The Institute also lobbied Policy Advice as it was then to make policy changes to effectively legislate the outcomes in Penny and Hooper to prevent any future abuse and make the rules clearer for all. The Institute's approach in this regard was rejected.

As above, I remain of the view that a better statutory framework is put in place to set the boundaries or limits on how income derived from a person's personal exertion is taxed.

I accept this essentially means a move closer to a more integrated basis of taxation – but in the context of personal services income there is a case for this.

However, I do not support moving to a more integrated basis for business taxation generally. Those proposals not only over tax business income they put material inefficiencies into New Zealand's small businesses and family arrangements.

While the Government has every right to consider a more integrated regime and how that could work, I would have expected that to have been the topic of a discussion document, rather than seeing this mooted as part of a discussion that was premised on small businesses avoiding tax under the guise of a document entitled dividend integrity.

In terms of the proposals to better capture ASC and capital gain amounts I note that currently these items are captured in accounting reports, but have no objection to rules that better ensures a permanent record of these amounts is kept. In this context, an option to consider is the time of paying a dividend as the time of confirming ASC amounts to IRD. This forces the matter to be considered if a share buy-back is undertaken, rather than when a return is filed.

Personal services attribution

The document asks:

Do you agree with the proposed removal of the "80 percent one buyer" test?

The test should be reformed. The default should be that where a person substantially controls the income then the income can be treated as belonging to that person. So, for example, a sole practice doctor or dentist. That is move the test to an income control basis.

Thus, even when staff are engaged to perform the services that give rise to the firms income, if the income is controlled by a key shareholder, stakeholder, or business owner then this income should be attributable to that person (after normal expenses).

If no one person has control over the income then attribution should not occur at all and the normal business rules / shareholder salary and dividend rules apply.

Do you agree with the suggested decrease in the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?

Attribution of personal services income is appropriate when derived by a person that has control over the income. Lowering the threshold is obviously one solution but the issue you have is when that is measured. You don't want to get to the end of the year to measure this as unexpected outcomes may arise. Rather the test needs to be understood at the outset. I prefer rights to control the business income.

In my view, when you have more people involved in delivering the services that generate the income then there is less risk the income is not taxed at the correct rate. As above, my preference is to focus on professionals that control the bulk of the income. So for example, a property valuer that has 2 staff who are also valuers can be considered to derive the bulk of the firm's income directly as that person has control over the treatment of the net income. On the other hand, a lawyer in a large law firm, although a partner, will not have control of the firm's income.

Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?

The original thresholds were arbitrary and so are the proposed thresholds. My view is that if the principal test is met the value of business assets it is irrelevant. However, my advice is consistent with the sole practitioner who has control over the income. If you lower the 80% one natural person test such that it would include two people performing the services then an allowance for substantial business assets is appropriate.

Closing comments

The income control test is potentially wide in that it will include professional people as well as trades people such as builders, plumbers, painters and electricians. However, at the end of the day, when the bulk of income is derived through a person's services and the income belongs to that person, the income should be taxed in that person's hands or at the tax rate of the person. For example, a sold trader company could pay tax at the shareholder's marginal tax rate instead of attribution. I note that this was proposed by the New Zealand Institute of Chartered Accountants and rejected by Inland Revenue.

Yours faithfully

s 9(2)(a)

Craig Macalister

Corporate Taxpayers Group

29 April 2022

Dividend integrity and personal services income attribution
David Carrigan
Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
PO Box 2198
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Dear David

DIVIDEND INTEGRITY AND PERSONAL SERVICES INCOME ATTRIBUTION

The Corporate Taxpayers Group ("the Group") is writing to submit on the Government Discussion Document "*Dividend integrity and personal services income attribution*" ("the Discussion Document").

GROUP PRIORITIES

As the following submission focuses on the Group's high-level and policy design considerations on the Discussion Document we set out below the Group's 4C's (referred to in previous submissions and correspondence with PaRS) which can be considered when reading the submission.

The Group believes that all policy proposals should be analysed with respect to the following:

1. **Contribution**: does the reform make a positive contribution to the tax system and therefore New Zealand?
2. **Competitiveness**: how does the reform improve the competitiveness of the tax system internationally, and how does the reform lead to increased productivity or innovation?
3. **Compliance costs**: does the reform reduce compliance costs, or does the tax in question warrant the compliance costs imposed?
4. **Certainty**: are the rules clearly drafted and easy to understand and comply with?

The proposals in the Discussion Document do not score well against the 4Cs.

GENERAL COMMENTS

The Group is concerned that this Discussion Document is proposing fundamental changes to the tax landscape, with wide ranging consequences which are not targeted at the underlying concern of taxpayers avoiding the 39% personal tax rate.

The proposals in the Discussion Document essentially seek to disregard the separate legal status of companies because the outcome is that retained earnings are taxed in the hands of shareholders regardless of what was received by the shareholder. The proposals operate on an assumption that a company and its controlling shareholder are essentially "as one" and disregards the fact that the earnings of a company (that hasn't elected to be a look through company) belong to the company. It is common, and sensible, business practice that an active business should retain some level of profits for the purposes of facilitating growth, such as investing in new assets, hiring new employees or

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We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

holdings earnings to remain resilient in case of changing market circumstances (such as a global pandemic[1]) as well as prudently meeting the solvency test(s) required by corporation law or third-party financiers banking covenants. The Discussion Document fails to consider that these reasons are generally why a company will retain profits rather than being driven by avoiding higher personal tax rates.

Paragraph 1.22 of the Discussion Document sets the tone for what the Discussion Document is trying to achieve when it states "*…the measures proposed focus on mechanisms that divert the income of a taxpayer on the 33% or 39% rate through channels that allow it to be taxed at a lower rate*". The Group accepts that the integrity of the tax system is of paramount importance and recognises that integrity measures in relation to the potential avoidance of the new 39% marginal tax rate through company structures may be appropriate. However, the proposals contained in Part 1 of the Discussion Document potentially capture normal commercial arrangements between unassociated taxpayers that do not circumvent the 33% or 39% tax rates.

The Group's submission focuses on the Proposals in Part 1 of the Discussion Document. The Personal Services Income Attribution rules discussed in Part 3 are of limited application to the Group, but the Group would like to note that it is opposed to these changes on the basis that they disadvantage small businesses and there is no clear need for reform to these rules.

PROPOSALS NOT JUSTIFIED BY THE STATED OBJECTIVE; THE OBJECTIVE CAN BE ACHIEVED BY ENFORCING EXISTING LAW

The Discussion Document is the latest example of a recent tendency by Inland Revenue to seek new prescriptive legislative rules as an alternative to enforcing the existing law.[2] The Regulatory Impact Statement (**RIS**) that accompanied the Discussion Document states (at [31]):

> *31. Non-regulatory options to address the problems identified include increased enforcement activity by Inland Revenue, including more guidance to taxpayers and education on what specific activities or behaviours Inland Revenue considers objectionable and will take action against where these are identified. However, these options have significant limitations, namely that they are heavily reliant on the general anti-avoidance rule and on increased operational resourcing for Inland Revenue.*

The summary table at page 12 of the RIS suggests that increased compliance activity (Option Two) would achieve the stated objectives without the complexity and increased compliance costs of the Discussion Document proposals (Option Three). But Option Two is ruled out "due to increased specialist resourcing requirements".

There is no evidence that Inland Revenue has encountered difficulties in applying the general anti-avoidance rule. On the contrary, it has in the past two decades had a high success rate before the courts in such cases, and has settled a far greater number of cases with the benefit of the case-law precedents.

More generally, Inland Revenue is a well-resourced agency. Its most recent annual report (to 30 June 2021) recorded that it had 4,106 FTE employees, and it has recently spent over $1billion transforming the way it operates and introducing a sophisticated computer system with significant data analytic capabilities. The proposition that it lacks the resourcing to enforce the legislation it is responsible for deserves scrutiny, and (if true) should raise concerns for Ministers and the New Zealand public.

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1 In relation to COVID-19, the Group notes that Inland Revenue should ensure it is viewing any data on tax positions taken since 1 April 2021 through a COVID-19 lens. In particular, paragraph 6 of the Regulatory Impact Statement accompanying the Discussion Document references lower earnings by taxpayers with an ownership/control relationship with an employing entity. Those lower earnings could be a direct result of COVID-19 lockdowns/restrictions since August 2021. In addition, when considering what amounts have been distributed from companies to shareholders, the impact of wage subsidies, resurgence support payments, COVID-19 support payments and the small business cash-flow loan should be considered; each of these schemes has resulted in businesses being discouraged from distributing amounts to shareholders.

2 An earlier example was the enactment of purchase price allocation rules (sections GC 20 and GC 21 of the Income Tax Act 2007), which have altered the bargaining power of parties to agreements for the sale of property or business assets by giving one party the power to unilaterally determine the allocation of the purchase price in certain circumstances. The reasons given for those new rules included that: "The parties may prefer not to agree an allocation… and <u>scrutiny from the Commissioner is unlikely to occur or, if it does occur, to result in any adjustment even where there is inconsistency</u>." [Emphasis added] (Purchase Price Allocation, Issues Paper (December 2019) at [4.2]).

In particular, given Inland Revenue's past success in invoking anti-avoidance rules, it is right to ask why Inland Revenue is now asserting that it lacks the resourcing to apply those rules, with the result that (as the RIS acknowledges) businesses (and therefore, ultimately, consumers) should bear the increased compliance costs of the more complex rules now proposed. It is also right to ask if it is fair that taxpayers who comply with their obligations and do not engage in tax avoidance should bear the increased costs of more complex rules as an alternative to Inland Revenue enforcing the existing law against the minority who are not compliant or who do engage in tax avoidance.

PROPOSALS WOULD IMPOSE NEW COSTS AND COMPLEXITIES ON BUSINESSES

Part 1 of the Discussion Document proposals would recharacterise the proceeds of sale by a controlling shareholder of shares in a company, by deeming part of the proceeds of sale to be a dividend. The proposals would affect the owners of the thousands of SMEs across the country who may wish to sell a controlling shareholding in their business.

The Prime Minister announced in April 2019 that the Government would not introduce a tax on capital gains. Among the arguments against introducing a comprehensive tax on capital gains was the concern that it would discourage innovation, would increase complexity and compliance costs (particularly when applied to the sale of a business), and (unless adequate exceptions were put in place) lead to 'lock-in' effects whereby the tax system becomes a barrier to businesses being sold when that would otherwise be the best outcome.[3]

The Discussion Document proposals raise those same concerns, in some ways in a more pronounced way than would be seen under a full capital gains tax. For example:

- Most capital gains taxes contain rollover relief and other exemptions to facilitate restructures of ownership or (for example) on death of an owner. The Discussion Document does not propose any such rollover relief, meaning the proposals could operate (for example) as a tax on the transfer of a business on the owner's death, or could be an impediment to some intra-group restructurings (for example, where a company, which may be ultimately widely-held, transfers a shareholding in a joint venture as part of an intra-group restructure).

- The Discussion Document expressly contemplates (at [3.41]) a business owner being taxed on an amount that exceeds the gain on sale of the shareholding. Take, for example, a small business, the owner's 100% shareholding in which had a cost base of $300,000. The business had been successful prior to the pandemic, and the company has retained earnings of $150,000. The pandemic has adversely affected the business's future prospects and the owner, who has reached retirement age, sells the shareholding for $200,000. The owner, therefore, sells at a loss of $100,000, but (under the proposals) would have income for tax purposes of $150,000.

MEASURES WOULD CUT ACROSS EXISTING TAX POLICY SETTINGS PUT IN PLACE TO FACILITATE CHANGES IN OWNERSHIP OF A COMPANY AND TO ENABLE NEW ZEALAND BUSINESSES TO COMPETE INTERNATIONALLY

The Government recently introduced a business continuity test which has the effect that tax losses may be carried forward despite changes in a company's ownership if a business continuity test is met. The stated purpose of this new test included reducing impediments to changes in the ownership of companies and to companies accessing new sources of share capital (Income Tax Act 2007, section IB 1).

A new tax rule that could see business owners taxed on the sale of a controlling shareholding (and sometimes on an amount of deemed income that exceeds their actual gain) plainly runs counter to this objective. The proposals, if implemented, will become a new barrier to changes in company ownership and to companies accessing new capital.

3 See the Minority View (of Robin Oliver, Joanne Hodge and Kirk Hope) on Extending the Taxation of Capital Gains (18 December 2018): https://taxworkinggroup.govt.nz/sites/default/files/2019-02/twg-bg-4050912-extending-the-taxation-of-capital-gains-minority-view.pdf.

The proposals also appear to cut across the exemption for certain foreign income that was put in place 15 years ago to help ensure that New Zealand businesses carrying on business through a foreign subsidiary were not at a disadvantage relative to their peers headquartered in other countries that already enjoyed such exemptions.
The exemption allows a New Zealand company to receive non-portfolio dividends from a foreign company free of New Zealand tax so long as the dividends received are retained in the company.

The then Minister (Hon Dr Michael Cullen), in outlining the exemption the Government was introducing, described the existing tax settings for outbound investment as "the best international tax system in the world if only the world had followed".[4] The exemption he introduced was described in the same speech as "modern pragmatism".

The proposals would cut across that exemption (by deeming the exempt foreign income to be distributed as a dividend on a change of controlling shareholding, even though it is in fact retained in the business). The proposals would also mark a shift away from the philosophy of "modern pragmatism" to which Dr Cullen referred, and back towards a pursuit of theoretical purity that would leave New Zealand businesses at a competitive disadvantage.

The proposals as they stand may also have an unintended impact on New Zealand's capital markets. As an example, the proposed rules incentivise a company to acquire 100% of a target (and not co-invest) to avail themselves of the inter-corporate dividend exemption should they later dispose of that entity. This could have a very serious impact on IPO activity and runs counter to the reforms made to the imputation regime to better accommodate co-investment.

OTHER SUBMISSION POINTS

- As alluded to above, the proposals in the Discussion Document are a clear example of overreach. The proposals have an incredibly wide scope impacting nearly all companies, when the mischief that the proposals are seeking to address is limited to a small subset of taxpayers. For example, the members of the Corporate Taxpayers Group would likely be impacted by these proposals when they sell investments/subsidiaries or look to internally restructure or acquire another business. The members of the Group are largely widely-held entities/groups and so should not be caught by reforms that are said to be necessary to address the avoidance of the top personal tax rates. Yet because the Discussion Document proposals have such a broad reach, members would need to incur significant compliance costs to understand and navigate the rules as proposed.

- The Group notes that Paragraph 1.13 of the Discussion Document states that when taxpayers can structure entities to avoid the 39% tax rate, this erodes public confidence in the integrity of the tax system. The Group agrees that public confidence in the tax system is important and that it ties back to the notion of tax certainty, one of the 4C's. However, the Group considers that if the proposals (as they currently stand in the Discussion Document) are enacted, there is no question that public confidence in the integrity of the tax system would be eroded due to the ad hoc and unfair nature of the outcomes under the rules. For instance, a set of rules that could see business owners taxed when they sell a shareholding at a loss is unlikely to improve perceptions of the tax system's fairness and coherence.

- The Group believes that the resources spent on preparing this Discussion Document would have been better spent evaluating the purpose of companies and evaluating if, at times, they should retain a separate legal identity for tax purposes and the reasons which exist for companies to retain income. This would provide the Government with a better platform to evaluate potential tax reform to ensure that proposals align with the policy objectives. This would allow Officials to gain a better understanding of the growth and productivity benefits that accrue from companies not fully distributing profits to shareholders on an annual basis.

4 Hon Dr Michael Cullen, "Building a strong economy and a fair society" speech notes for address to Auckland Chamber of Commerce (10 February 2007).

- To follow on from the point immediately above, and with reference to Paragraph 2.5 of the Discussion Document which deals with potential solutions with how to deal with integrity issues around share sales, the Group believes that more consideration should be given to what is the better answer to the problem. The proposals in the Discussion Document in effect create a way to tax capital gains, but come with some significant issues as the Government has ruled out a comprehensive capital gains tax. In some respects, the Discussion Document proposals (given their breadth, and proposed application to sales of companies to unrelated persons) could be seen by some as an attempt to tax some capital gains (despite the Government's commitment not to do so) but in an ad hoc and unprincipled way that creates various distortions and complexities as explained elsewhere in this submission.

- The Discussion Document proposals appear to assume that all retained profits in a company relate to undistributed cash. The Group notes that these retained profits may relate to the revaluation of assets rather than the operation of the business. While the Discussion Document indicates at paragraph 3.35 that retained earnings could be adjusted to remove non-taxable capital gains (which would presumably include asset revaluations), the Group questions whether businesses will have to keep a detailed reconciliation of how retained earnings arose. This has the potential to increase complexity and compliance costs. The Group is concerned that this has the potential to not only over tax but also to provide a different outcome from what would occur under a liquidation which results in further distortions.

- The Group is concerned that in its current form, the proposals may encourage owners of businesses to "strip out" surplus cash from the business as an immediate cash benefit would be better now than later if there is a disincentive to retain it. The Group believes it is in New Zealand's best interests to retain surplus cash to reinvest in businesses for purposes such as R&D, new markets, or products and to maintain a strong balance sheet. The inference that Inland Revenue interprets retaining earnings as motivated by avoiding taxes for shareholders could skew whether a business decides to retain cash in the business. The current proposals may result in business owners changing their behaviours in relation to the retention of capital which is a concern to the Group.

- It is assumed in the Discussion Document that purchasers purchase businesses with cash. It is the Group's experience that purchasers do not want to pay for cash. Therefore, if Inland Revenue posits cash as being deliberately not distributed to gain a tax advantage, this is already likely to exit the business in the form of a dividend prior to sale anyway resulting in no tax avoidance. No one pays cash for cash so the thesis that cash is being locked up pending sale lacks commercial sense.

- The Group is concerned that essentially creating a new exit tax on shares when none previously existed will disincentivise serial entrepreneurs from starting new ventures. This is inconsistent with the general notion of wanting to incentivise growth and development for the benefit of the New Zealand economy. The Group questions why individuals would bother taking on the considerable entrepreneurial risk that can exist when creating capital value when they are risking tax on any upside but no support on any downside (and the risk of tax being payable in circumstances where they sell a shareholding at a loss, as explained above).

- The Group notes that some issues may arise in relation to locked box transactions. The profits earned between the locked box date and the completion date economically belong to the purchaser and are at risk to the purchaser so the vendor should not be subject to tax on these, yet the proposals would appear to have that effect.

- If acquiring a privately owned operating company that pays provisional tax, the Group notes the Imputation Credit Account balance may be left behind to enable a refund of pre-acquisition income tax paid (i.e. the company overpaid income tax but the Inland Revenue will not refund before the return is filed, so the balance sheet records a current tax asset and ICs are left behind to enable the refund of that tax). If the imputation credits are deemed to be fully utilised by the vendor then this will result in trapped cash for the purchaser.

- The proposals are unclear when it comes to corporate group restructures. Paragraphs 3.46 – 3.50 and Example 7 are very difficult to follow, and the suggestion that we should be modelling rules after the United States is questionable given our very different tax systems. It's unclear from the proposals as they currently stand whether they would result in simpler or more complicated structures, but it's likely that many corporate groups could find themselves having to incur significant compliance costs if they are trying to undertake restructures / reorganisations.

- At Paragraph 2.23 of the Discussion Document, it is stated that since the first increase of the top personal tax rate to 39%, New Zealand has seen an increase of the imputation credit account (ICA) balances of non-listed companies which suggests that fewer and smaller dividends are being paid to shareholders. The Group believes that more analysis should be provided in relation to this statement. The Discussion Document appears to suggest that the tax rate differential is the reason for this profit retention. The Group, however, hypothesises that the reason is that companies are encouraged to invest in growth rather than distributing short term income for shareholders. With more research into the reason behind increasing ICA balances Officials will have a better understanding of the motivations of companies and will be in a better position to create targeted rules to address avoidance of the 39% marginal tax rate.

- The Group notes that the examples provided in the Discussion Document are too simplistic and do not accurately reflect commercial reality in a number of ways, the first and foremost of which is that the Discussion Document assumes a company is worth its net asset balance. In relation to Example 1, just because Bullseye has $100 capital and has made $72 after tax does not mean "Bullseye is now worth $172". A valuation of Bullseye would need to, at the very least, take account its potential to earn future income and not just its assets. The examples also assume that business structures are straight forward. As demonstrated by the Discussion Document the proposals become increasingly complicated when there are group companies (example 6), for example determining the ICA and ASC balance for all entities in a group and then calculating the required adjustments. The Group notes that the structure included in example 6 is relatively straightforward, yet would require complicated time consuming calculations to determine the tax payable upon a deemed distributed. This would only compound in the instance of a large corporate group structure of up to 20+ entities where some are partly owned, or look through companies / trusts / partnerships are partly involved.

- The Discussion Document also assumes that all shareholders are subject to the 39% personal tax rate and that the sale of shares in a company will always result in an 11% tax leakage. This will not always be the case and many of the small businesses that these proposals will impact will have owners that earn less than $180,000 per annum where any tax leakage (if any) is only 5% or less which has been the case for some time with no concern.

- The proposals also result in over taxation. In Example 5, (noting we don't have details of other income earned) Paul is being taxed on the deemed dividend at the 39% tax rate despite the profits being accumulated over 15 years, for many of which the top personal tax rate would have been 33%. In addition the proposals can result in very high tax levels. For example:

  A buys 100% of the shares in ABC Limited for $5million. At the time, ABC had retained earnings of $1million. Over time A operates the business and retained earnings increase to $2million, and the ICA balance is $388k. A is approached by Y who wants to acquire ABC for $6million. This is a $1m capital gain for A.

  A has a deemed dividend of the greater of:

  - $2m + $388k = $2.388m
  - $388k / 28% = $1.385m

  A has a tax obligation of $2.388m x 39% - $388k = $543k. While A has made a capital gain of $1m, this has an effective 54% tax applied because A is also being tax on the retained earnings which existed at the time A acquired ABC Limited.

- The Group would also like to point out the complexity of the proposals and how these would only result in reduced certainty and higher compliance costs for taxpayers. To demonstrate this the following points identify just some of the issues that would require further consideration and could perhaps further complicate the proposals if they were to make it into law:

a) The look back rule as proposed at paragraph 3.24 of the Discussion Document will be problematic for succession planning in private companies, including progressive sell downs to employees. For example, the rules would apply to a privately owned business which introduces an employee share scheme in the years before the business is sold. The complexity of the rules would provide a barrier to privately owned companies introducing employee share schemes.

b) The Group is concerned with how the proposals will work when there are different classes of shares with different attached rights being sold. For an example, preference shares with fixed/capped dividend entitlements or shares with a preference which is typical when dealing with private equity backed companies. The Group also questions how this will interact with benchmark dividend rules for imputation credits.

c) In relation to Example 4, if a company has non-deductible expenses in prior years, there would be excess taxation. The ICA balance would exceed the ability of the business to distribute dividends and tax on the shareholder would exceed economic income which makes no commercial sense.

d) Certain types of foreign income (FDR income being a common example) differ to the actual/economic income earned by a company. This is therefore another example where the use of imputation credits in the calculation of a deemed distribution results in the deemed distribution not aligning to commercial reality.

e) Given the proposals relate to retained earnings balances for financial reporting purposes, it is unclear how the rules can be applied if a transaction occurs between financial reporting balance dates. Will the rules require taxpayers to prepare part-year financial statements and tax returns in order to quantify the amounts subject to the rules?

f) If acquiring a privately owned operating company that pays provisional tax, the Imputation Credit Account balance may be left behind to enable a refund of pre-acquisition income tax paid (i.e. the company overpaid income tax but the Inland Revenue will not refund before the return is filed, so the balance sheet records a current tax asset and imputation credits are left behind to enable the refund of that tax). If the imputation credits are deemed to be fully utilised by the vendor then this will result in trapped cash for the purchaser.

g) If retained earnings are attributable to a period when the top personal tax rate was under 39%, should the resulting dividend be taxed at the lower rate?

- In relation to Part 2 of the Discussion Document, the Group agrees that taxpayers should maintain records of Available Subscribed Capital and Available Capital Distribution Amounts however it does not think these accounts should be required to be filed, particularly if the amounts have no relevance to the tax positions taken by businesses. Business should be aware that there will be a need to substantiate an ASC/ACDA amount if a taxpayer wants to use these amounts. If the Inland Revenue expects taxpayers to maintain these records and file them with Inland Revenue then a statute bar should apply to those records. The Group notes that Inland Revenue should not underestimate the complexity in maintaining these accounts for large and complex groups.

Please let us know if you have any queries in relation to the matters set out in this letter, otherwise we look forward to meeting with you to discuss this submission on 11 May 2022.

For your information, the members of the Corporate Taxpayers Group are:

1 AIA New Zealand Limited
2 Air New Zealand Limited
3 Airways Corporation of New Zealand
4 ANZ Bank New Zealand Limited
5 ASB Bank Limited
6 Auckland International Airport Limited
7 Bank of New Zealand
8 Chorus Limited
9 Contact Energy Limited
10 Downer New Zealand Limited
11 First Gas Limited
12 Fisher & Paykel Appliances Limited
13 Fisher & Paykel Healthcare Limited
14 Fletcher Building Limited
15 Fonterra Cooperative Group Limited
16 Genesis Energy Limited
17 Heartland Bank
18 IAG New Zealand Limited
19 Infratil Limited
20 Kiwibank Limited
21 Lion Pty Limited
22 Mercury NZ Limited
23 Meridian Energy Limited
24 Methanex New Zealand Limited
25 New Zealand Superannuation Fund
26 Oji Fibre Solutions (NZ) Limited
27 OMV New Zealand Limited
28 Pacific Aluminium (New Zealand) Limited
29 Powerco Limited
30 Resolution Life Australasia Limited
31 SkyCity Entertainment Group Limited
32 Sky Network Television Limited
33 Spark New Zealand Limited
34 Summerset Group Holdings Limited
35 Suncorp New Zealand
36 T & G Global Limited
37 TAB New Zealand
38 The Todd Corporation Limited
39 Vodafone New Zealand Limited
40 Watercare Services Limited
41 Westpac New Zealand Limited
42 WSP
43 Xero Limited
44 Z Energy Limited
45 ZESPRI International Limited

We note the views in this document are a reflection of the views of the Corporate Taxpayers Group and do not necessarily reflect the views of individual members.

Yours sincerely

s 9(2)(a)

John Payne
For the Corporate Taxpayers Group

CC Michelle Redington
Cath Atkins
Sharon Thompson
Tony Morris

Building a better
working world

Public.Consultation@ird.govt.nz 29 April 2022

Dear Sir/Madam

Submissions on “Dividend integrity and personal services income attribution” discussion document

We refer to “Dividend integrity and personal services income attribution” (or “Discussion Document”) first published in March 2022. Thank you for the opportunity to make this submission. We set out our general comments below, and specific submissions on the proposals in the attached Appendix.

The proposals as outlined should not proceed

In our view the proposals as outlined in the Discussion Document should not be progressed. The proposed changes go far beyond supporting the integrity of the top personal income tax rate. A decision to move New Zealand tax settings towards greater integration of corporate income is a significant departure from the status quo.

The Discussion Document does not in our view adequately outline the breadth of what is being proposed, nor include adequate consideration of the various flow-on consequences that would arise. Instead, the broad-reaching proposals are labelled as integrity measures, which belies their significance.

We are concerned that the deemed dividend and personal services amendments, in particular, will have significant overreach applying to scenarios which pose little or no integrity risks to the tax system. Appropriate integrity measures that protect the tax base are warranted, but what is being proposed in this Document in our view goes well beyond that.

Significant reforms to the proposals are needed to make them workable and better targeted at the integrity risks. Alternatively, a move towards greater corporate income integrations needs more careful policy consideration. In either case, we would not want to see the proposals as outlined rushed through Parliament.

Officials should take the time to work through the issues raised by submitters ahead of making broad sweeping reforms.

The volume of current consultations undermines effective consultation

Furthermore, we regret that we have not been able to dedicate as much time and effort into considering these proposals as we believe is warranted, given their significance. This is because this consultation falls at the same time as active consultation on many other significant proposed changes. This is also the busiest time of year for tax professionals.

We are concerned that issues will therefore be missed, and retrospective legislative fixes will be needed in time to correct mistakes. While we appreciate that officials are working to a set legislative timetable, we would prefer officials to take additional time to consider the proposals more carefully.

Building a better
working world

More generally we would like to see more active management of the consultation volumes and timing of release across Inland Revenue, to better support the generic tax policy process ("GTPP") and the ability of submitters to support policy design through active consultation.

We welcome any discussions you may wish to have with us on the matters raised below. Please contact Sladjana Freakley in the first instance on s 9(2)(a) or at s 9(2)(a).

Yours faithfully

s 9(2)(a)

Paul Dunne
Partner | Tax Policy Leader
Ernst & Young Limited
s 9(2)(a)

Appendix

Detailed submissions

A - Dividend Integrity

1. *Policy outcomes go beyond addressing integrity risks*

1.1. As noted above, the dividend proposals would have effects beyond those stated in the Discussion Document. Fundamentally, a decision to seek greater integration of corporate incomes is a policy decision that cannot be viewed as merely an integrity measure to support the 39% rate.

1.2. Integrity concerns typically relate to taxpayer behaviours that undermine the intent or application of the law. Usually, these behaviours involve contrived and dishonest actions or structuring to avoid or undermine tax laws. We would be concerned if the choice to not distribute all corporate earnings was somehow seen in the same light. In our view further indicators of integrity concerns should be present, before corrective action is applied. That approach ensures the rules are appropriately targeted at the problematic behaviours.

1.3. We support measures that improve the integrity of the tax system, but those integrity measures should in our view be appropriately targeted at the problematic behaviour. Broad brush proposals that apply to all small and medium enterprise (‘SME’) corporate structures, ignoring specific taxpayer motivations and behaviour, go too far.

1.4. If the Government wants to consider greater corporate income integration, the policy discussions should reflect that intent and outline the related implications. We do not think integrity concerns should be used as justifiers for such broad policy proposals.

2. *Corporate retained earnings do not indicate that an integrity problem exists*

2.1. The Discussion Document appears to suggest officials are concerned with the degree of earnings retention and high levels of imputation credit account (‘ICA’) balances in New Zealand companies, as indicative of an integrity issue. In our view, retained earnings and high ICA balances should not immediately be seen as integrity risks. Businesses retain earnings for a variety of reasons. Profits accumulated in ‘SMEs in particular are most commonly reinvested into the capital of these enterprises. This investment directly grows New Zealand businesses and the economy.

2.2. Much of the retained earnings (in the companies targeted by the proposals) was likely generated before the reintroduction of the 39% rate for individuals, and even before the reduction of the corporate rate to 28%. Therefore, it is difficult to see why retaining earnings ought to be seen as a risk to the 39% rate in the absence of additional indicators of foul play.

2.3. Further, in our experience, share sale transactions do not involve the sale of cash. It is not commercially advantageous for investors to acquire cash-heavy businesses, and purchasers routinely require surplus cash to be paid via pre-completion dividends. As such we question the degree of the stated integrity risk that the proposals aim to address.

3. *Capital gains taxation should not be introduced by stealth*

3.1. The proposed changes appear to be an attempt to resolve issues caused by New Zealand’s lack of a comprehensive capital gains tax. The current Labour government has repeatedly publicly stated it will not implement a capital gains tax. Yet the current proposals would tax capital gains on in-scope share sales.

3.2. If Parliament's intention is to tax capital receipts, then Parliament should introduce a capital gains tax. Piecemeal amendments that tax only certain capital gains, erode the coherence of the tax system and arbitrarily pick winners and losers.

3.3. We question the justification for taxation of only certain capital gains, earned only by certain taxpayers. If integrity and fairness are the motivations behind these proposals than it is unreasonable to exclude large, listed and foreign-owned companies from the proposals, while targeting closely controlled SMEs. Similarly, we question the justification for ignoring share sales by minority shareholders, given the same tax outcomes arise for all shareholders in these companies. In our view none of these differentiations are justifiable from a policy perspective.

4. *Existing avoidance measures can address integrity concerns*

4.1. The Discussion Document acknowledges there are already rules to address dividend integrity issues. Two of the three examples provided involve transactions where the ultimate economic ownership doesn't change, and officials note existing rules apply in these circumstances. If these rules are inadequate, then changes should be limited to bolstering the rules, not broadening them to apply to non-problematic scenarios.

4.2. The Discussion Document appears to suggest the real issue may not be with the adequacy of existing rules, but with Inland Revenue's ability to enforce them. For example, at [3.3] officials note failure to follow existing rules may "not be known or pursued by Inland Revenue". We suggest that problems enforcing the current rules would likely extend to the proposed changes.

4.3. If law changes are needed to support Inland Revenue's effective enforcement of the avoidance rules, then targeted measures to address specific failures in the current settings are warranted. Specific anti-avoidance rules that apply in cases of clearly problematic behaviour can be designed. But that is not what is being proposed here, instead all share sales regardless of motivation or outcome are caught.

4.4. We observe the move from rules that consider all relevant facts and intentions to "brightline" type tests is becoming a broader trend in New Zealand's tax policy settings. While brightline tests are easier to evidence, and therefore enforce, they are also blunt tools. Brightline tests do not target their application as well as tests that consider specific facts and circumstances. Corrective action is applied more broadly as a consequence, which can result in unfairness.

4.5. In our view additional tests are needed here, such as a requirement for the structure or transaction to be contrived, lacking in substance, or resulting in no meaningful change in economic ownership. That approach ensures the corrective action (deeming the dividend to arise) is better targeted at the problematic behaviour.

5. *Proposed changes do not achieve equity between shareholders that have received regular dividends and shareholders of companies that have reinvested retained earnings*

5.1. Officials appear to be of the view that retained earnings should properly be paid out as regular taxable dividends, and that the proposed changes would achieve an equivalent result from a tax perspective.

5.2. Retained earnings will in many cases have built up over many decades. If the rules presume dividends should have been paid regularly over time (including years where shareholders' tax rates may have been much lower than 39%), then deeming income to arise in the year of sale is punitive. This approach artificially forces shareholders into the top marginal rate and taxes only those shareholders that own shares at the point of sale.

5.3. By focussing on retained earnings in a Discussion Document considering integrity issues, officials appear to be suggesting that shareholders are choosing not to pay dividends in order to avoid paying income tax at the top marginal tax rate. In our view this presumption is false. The top rate of 39% was not in existence at the time much of the retained earnings were accumulated. Furthermore, many shareholders would have been subject to much lower marginal rates at the time decisions were made to reinvest rather than pay out dividends.

5.4. Finally, the proposed changes represent a form of dividend streaming. The shareholders affected by the proposals are those "holding the baby" at the point of sale. Given the arbitrary threshold of 51%, retained earnings may have been accumulated during periods the controlling shareholder had a non-controlling interest in the company.

6. *Behavioural changes have not been adequately considered*

6.1. We are concerned that the Discussion Document does not appear to recognise nor consider the wide-reaching implications of these proposals. In our view, the proposals will lead to widespread changes in investment behaviour in New Zealand. Yet the Discussion Document does not discuss these outcomes, nor propose mitigations to the extent the consequences are undesirable.

6.2. Before the proposals are progressed further, careful consideration of the impacts of these changes is necessary in light of their effect on the wider economy.

6.3. We list below several behavioural consequences we believe officials ought to consider further before progressing these proposals:

- The proposals will discourage investment in New Zealand businesses, slowing growth and the drive for productivity increases.
- Investors would be incentivised to invest in offshore businesses or to prioritise overseas expansion over domestic growth, which is not good for the New Zealand economy.
- Shareholders will be incentivised to proceed with asset sales over share sales which undermines the intent of the rules.
- The proposed changes incentivise investors in growth and start-up businesses to divest interests at earlier stages, distorting taxpayer decision making contrary to the BBLR principles underpinning New Zealand tax policy design.
- The proposed changes would incentivise investment by and sales to offshore investors and shareholders holding less than 51% of a company's shares (including those working in concert with non-associated persons), as these shareholders attract more favourable tax treatments under the proposals. This further compounds New Zealand's growing wealth inequity issues.
- The proposals favour "big business", which may have a focus on short-term investor returns over long-term investment and growth. The focus on SMEs over listed and foreign companies appears unjustified and arbitrarily picks winners and losers.

- The proposals would unfairly restrain SME businesses from restructuring for succession planning, compared with larger listed corporates.

- Many divestments of New Zealand SME businesses occur in the course of owner retirement. This proposal will disincentivise these retirees from making investments that would inject capital into the economy more broadly. That is because the return on productive investments would be weighed against a guaranteed tax saving of 11% if dividend income was distributed slowly over retirement.

- The proposals will disincentivise routine and beneficial commercial practices such as the implementation of employee share schemes.

6.4. In our view the proposals overall distort investment behaviour in a way that negatively impacts growth and productivity. We believe that the negative consequences of these behavioural changes will outweigh the increase in revenue that would be raised if the proposals were progressed.

7. *Practical issues not considered*

7.1. The Discussion Document is particularly light on key details about how the proposed changes would work in practice. There are many practical issues that appear not to have been considered. For example, how double taxation would be prevented in successive commercial transactions, and how the associated persons rules would apply or be enforced. These issues will need further consideration before the proposals could be progressed.

B - Personal Services Attribution rules

8. *Proposals go too far and should not proceed*

8.1. Similar to our submissions on the deemed dividend proposals, we believe the proposed amendments to the Personal Services Attribution rules go too far. The reformed rule would apply to alter tax consequences in circumstances well beyond the integrity scenarios for which it was initially designed.

8.2. In our view this rule is aimed at individuals who are in “disguised employment”. Whereas *Penny and Hooper* was concerned with structuring to avoid top tax rate through the payment of unrealistic salaries. The Discussion Document appears to conflate these two issues. Widening a rule aimed at addressing disguised employment, to effectively tax all services businesses as if they were sole traders, goes beyond scope. We question the rationale for distinguishing between service providers and sellers of goods, which is in effect what these proposals would do.

8.3. Therefore, we do not support the removal of the 80% one buyer requirement or broadening of the significant asset tests. These tests are necessary to distinguish employment-like arrangements from a broader class of services businesses which should not be subjected to this rule.

8.4. If there is a specific avoidance concern not addressed by the personal services attribution rule, we recommend implementing an appropriate but targeted solution. The proposals should seek to identify problematic scenarios and to target those. A decision to more broadly move towards greater corporate income integration cannot be seen as an integrity measure.

C - Available Subscribed Capital reporting

9. *Support for reporting mechanism*

9.1. We recently provided comments on the draft operational statement *ED0239 Available Subscribed Capital record keeping requirements* confirming our support for policy measures implementing the reporting of ASC and ACDA to Inland Revenue. The Discussion Document is silent on this recent consultation process and whether those submissions have been considered by Policy officials.

10. *Annual reporting is preferable, but time bar should apply*

10.1. Consistent with our submission in the paper referred to above, we support a mechanism for reporting ASC and ACDA annually. However, a time bar mechanism should also be implemented to achieve a level of certainty for taxpayers.

10.2. This allows for manageable record keeping when compared with the status quo. Given that presently companies would need to maintain decades' long records which, as acknowledged in the Discussion Document undermines accuracy. A time bar that provided 4 yearly certainty would allow taxpayers to align ASC and ACDA records with the standard 7-year retention requirement. This would alleviate compliance costs and improve integrity.

s 18(c)(i)

C/- Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department

By email: policy.webmaster@ird.govt.nz

27 April 2022

Re: Dividend integrity and personal services income attribution

Dear Sir

Thank you for the opportunity to submit on the proposed Dividend Integrity and Personal Services Attribution rules published on 16th March. We support a comprehensive discussion on the proposed rules, as small businesses are the backbone of our economy. We are happy to talk to our submission, our contact details are below.

We support the recommendations made by the Tax Working Group and suggest these should be referred to in proposing structural changes to the Income Tax settings.

Part I: Sale of Shares

Comments on questions for submitters:

- Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?

We submit that deeming a dividend to arise unilaterally when shares are sold, based on the company's retained earnings is not appropriate as an income tax policy, since the retained earnings amount does not reflect the real economic gain made by the shareholder. If the intention is to tax the gains made by the shareholder over the time of their owning the shares that have not already been taxed as dividends, then a comprehensive capital gains tax would be more appropriate.

The situation where shares can be sold to a company, and that acquiring company being able to pay out the previous shareholder the retained earnings of the original company avoiding the top personal tax rate that would apply to a dividend can be prevented by a deemed dividend rule which applies only to the sale of shares from an individual or trust to

s 18(c)(i)

a company. This limited-scope option would be appropriate as a tax-avoidance prevention measure while not creating a large compliance burden on small businesses.

Small businesses are typically funded by retained earnings or shareholder loans, rather than issuing shares and holding share capital. By leaving their profits in the company, the shareholder is putting that money at risk. Corporate tax rates are typically low by design, and this encourages businesses to retain funds to reinvest into business activity and strengthen their balance sheets, which in turn helps the growth and stability of the economy.

It is common for small businesses to sell shares of less than 34% from the controlling shareholder to the next generation; or to a key employee as part of the succession planning process. This is often done in stages and is an important process in the long-term viability of private enterprise. The sale is within the threshold to carry forward Imputation Credits, and typically retained earnings have been used to fund the working capital and capital assets of the business so cash is not available to pay out large dividends in cash. If the business is in a position to pay regular dividends, over time the new shareholders will use their dividends (taxed at their personal tax rate) to pay the original shareholder for their share purchase. This results in no tax leakage and allows business to sustainably manage succession.

The driver for the proposed changes is the differential between the top personal tax rate and the corporate tax rate. This gap is not large compared to other countries, such as Australia which has a corporate tax rate of 25% (for companies with up to AUD 50m revenue) for the 2022 financial year, and a top personal tax rate of 45%. The absence of a comprehensive capital gains tax in New Zealand results in unequitable tax outcomes and should be addressed directly rather than indirectly, the changes applying to all asset classes and investor types, not just small private business.

- Should the scope of the proposed recharacterisation rule cover all of scenarios A, B, or C, or only one or two of these scenarios?

It is only the sale of shares to another company, such as described in Scenario A and B that allows earnings to be paid out to the original shareholder at the company tax rate. In the case of a sale to an individual such as Scenario C, that individual will have to pay for the shares from after-tax income, which was taxed at their personal tax rate, so there is no tax leakage in that scenario.

- Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?

Limiting the scope of the proposed recharacterisation rule based on a control percentage creates distortions. An individual may purchase shares in a listed company for the general purpose of financial benefit, and not be taxed on the resale. The same investor might buy 51% of a private company and pay 39% tax on the eventual gain on resale.

We submit that the deemed dividend rule should be limited to the sale of shares from an individual or trust to a company. This should apply regardless of whether that shareholder was a major or minor shareholder.

- Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?

We submit that it is not appropriate to assume that all undistributed income equates to a dividend as this does not reflect the realities of business. In the “Other issues” heading 3.42, the document notes that the retained earnings might be used to fund capital losses. This is common, for example a business may make an acquisition that is not successful and have to write-off the goodwill. In private enterprise retained earnings would have been risked to make the investment and ultimately fund this non-deductible loss.

- What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two), and which of these approaches do you prefer? Is there an alternative approach you would suggest?

The deemed dividend quantification approach should be designed to reflect as close as possible the actual economic gain received by the seller.

We submit that the value of the benefit should be based on the retained earnings balance at the most recent balance date.

To reduce compliance costs, it would be preferable to use the opening retained earnings figure rather than the exact equity at the time of sale, since the share sale could happen at any time during the year and calculating retained earnings at the exact date reliably would be unrealistic for many small businesses.

By way a suggestion, consideration could be given to the actual share price if this is less than the retained earnings due to capital losses incurred by the company.

- Do you agree with the proposed approach (outlined in Example 3) for calculating dividends and ASC adjustments for corporate groups?

A dividend from a company within a group of companies is currently exempt income, we submit that this should be no different for deemed dividends.

- Is the approach outlined in Example 4 for a sale of one controlled company to another (existing) controlled company (potentially generating a deemed dividend from both companies) correct conceptually?

We submit that the deemed dividend should only arise on the sale of shares from an individual or trust to a company, not from a company to a company, or from any entity or individual to an individual.

Part II: ASC and ACDA tracking accounts

• Whether the proposal strikes an appropriate balance between compliance costs and tax integrity.

We submit that the rules should be simplified as detailed in the submissions above to be more easily understood an applied consistently.

• Whether the ASC and ACDA memorandum accounts should be reported in annual returns.
The amount of equity that was taxed as a deemed a dividend could be identified separately in the company financial statements and reported in the IR10, rather than maintaining extra memorandum accounts.

Part III: Personal services income attribution

Questions for submitters
• Do you agree with the proposed removal of the “80 percent one buyer” test? Why/why not?

We do not agree with removing the test. There are many reasons why a small service business might choose to operate through a company rather than directly and to retain income within the company. There are already robust rules to tax the provision of private benefits by a company to an employee or shareholder and these are sufficient to prevent abuse of companies for tax avoidance.

Removing the rule would penalise small service businesses that are starting out with a small asset base while they build up equity.

• Do you agree with the suggested decrease in the threshold for the “80 percent one natural person supplier” test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?

Reducing the threshold from 80% to 50% would be likely to catch more of the smaller business starting out who are still reliant on a few customers. The young family starting out in business even in a small way needs to be retaining company profit to grow a business venture which should only be taxed at 28% on that retained income. This is particularly true of businesses requiring assets and machinery in order to grow.

- Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?

A small company is likely to have a passenger vehicle as a key business asset, either a car for a travelling salesperson or a work van. For a small business their home is normally also their workplace, so the vehicle isn't used for travelling to work, but for travelling to do the work. The definition of passenger vehicles needs to be clarified – potentially referencing work related vehicles under the FBT rules. We agree with point 7.10 that increasing the threshold is not as likely to impact legitimate small businesses due to the 25% rule.

- Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter?

- Do you consider the net income threshold should be increased from $70,000 per year to $180,000?

If the "80 percent one buyer" test remains at 80% we don't feel this is necessary.

In summary our submission is that companies are a practical commercial structure that works for many businesses, large and small, public and private. The relatively low company tax rate encourages entrepreneurship, investment in productive assets and maintenance of a strong balance sheet – keeping the NZ economy stable and growing. Any changes to tax the retained earnings in a company need to simply address the actual issues relating to dividend stripping in share sales to companies, however in order to achieve the state objectives of this proposal we see the consideration of a comprehensive capital gains tax as the only equitable solution.

We would welcome the opportunity to discuss the points raised in this submission should this be desired.

Yours faithfully

s 9(2)(a) [redacted]

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PUB-027

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2 May 2022

David Carrigan
Deputy Commissioner
Policy and Regulatory Stewardship
Inland Revenue
PO Box 2198
Wellington 6140

By email: policy.webmaster@ird.govt.nz

Dear David

Discussion document - Dividend integrity and personal services income attribution

Our submissions covers all three proposals on the above discussion document.

Taxation of the sale of shares

1 The government proposes that when a shareholder sells their shares, they will be taxed as a dividend on a portion of the shares if:

a. They are a controlling shareholder; or

b. If they are "acting together" with other shareholders where they and the other shareholder control the company.

2 The taxable dividend will be the greater of;

a. The shareholder interest in the retained earnings of the company (grossed up for imputation credits)

b. The quantum of imputation credits in the company (gross up by the tax rate).

3 We disagree with the proposal for the following reasons:

a. **There is no clearly articulated policy objective that the proposal is targeted at.** The stated problem is avoidance of the 39% tax rate by earning income in a company. The proposal seems targeted at the SME sector. Our experience is that most SME owners extract as much profits as they can from the companies they control because they need to do so to meet personal expenditure commitments. Such payments from the company will be taxed at the shareholder's marginal tax rate. The Document does not support the significant change to the law proposed based on any evidence that avoidance of the 39% rate is widespread in the SME sector. Moreover, the proposal is not limited to situations where a person on a 39% marginal tax rate could be said to derive income through a controlled company. For example, the proposed rule could tax at a 39% tax rate the sale proceeds of shares in a company where the combined company taxable profits and shareholder income never exceeded $180,000. That is because the income derived over a number of years would be deemed under the proposal to be derived in the year the shares are sold.

b. **The proposal would deem the consideration for the sale of shares to be a dividend when it clearly is not a dividend in form or substance.** Broadly, for tax purposes a dividend arises when what is in effect the retained earnings of a company are distributed to shareholders. There are deemed dividends covering, for example, expenditure incurred for the benefit of shareholders. There is then no distribution of the company's retained earnings but there is the economic benefit of not earning revenue it would otherwise have earnt to the benefit of the shareholder. In the case of the sale of shares, however, there is no dividend equivalent transfer of value from the company to the shareholder. The retained earnings remain in the company and will continue to be taxed as a dividend on distribution. That is unless under the proposal to increase ASC is able to be distributed tax-free (see below). It is true that the vendor shareholder accesses cash from the share sale but that is paid by the purchaser not the company. This is not a dividend but a payment by the purchaser for the dividends that will be paid in the future.

c. To reduce double taxation, when a deem dividend arises when a shareholder sells shares, a portion of the retained earnings is converted into ASC. This is extremely complex and will create many errors, especially in group situations. Further and more concerning there are considerable restrictions when a company can return ASC and therefore this proposal will likely prevent companies paying dividends or result in double tax.

d. **Taxing the gross proceeds from the sale of shares will in some cases result in taxable income exceeding the economic income of the shareholder**. This can arise in a number of situations such as when the shareholder had previously acquired the shares and there existed pre-acquisition retained earnings. The document provides conflicting comments on this including is no deduction for pre-acquisition retained earnings to there being a deduction in the group context. Such an outcome is bad policy.

e. **The proposals are not practical and therefore not workable without substantial compliance costs**. The workability of the proposals requires detailed analysis. The proposals rely on the calculation of retained earnings however the Document assumes this is a given. There needs detailed discussion how this is calculated and what rules are to be applied to this especially noting most taxpayers caught by these rules are not subject to accounting standards. Taxpayers with identical commercial position but different accounting treatment will have completely different tax implications, this is an interesting outcome. As noted above, to reduce double taxation, when a deem dividend arises, a portion of the retained earnings is converted into ASC. This is extremely complex and will create many errors, especially in group situations. Further and more concerning there are considerable restrictions when a company can return ASC. Therefore the proposal will likely prevent companies paying dividends or result in double tax. Finally, applying the proposals to the sale of a single company is complex, however where there is a group of companies, this compounds the complexity.

f. **Taxing the greater of retained earnings and the gross up of imputation credits will add to the problems**. Where there is non deductible revenue (or capital expenditure) there will be surplus imputation credits in excess of the retained earnings of the company. Where shares are sold and the proposed tax is triggered, assuming there is either ASC or capital gains, there will be a tax liability greater than the revenue reserves. This is clearly over taxation and the Document does not explain why this is justified.

The adverse economic effect of the proposals would outweigh any base protection it might achieve. The proposal will result in a tax liability for shareholders when they dispose of shares and this will undoubtedly prevent some commercial transactions from occurring. This can apply when introducing employees, succession planning and mergers and acquisitions.

We understand officials are now focussing on example A, namely where a company is sold but the major shareholder retains ownership. As an initial comment we are not sure why the existing avoidance provisions do not adequately address this situation as we understand the Inland Revenue has been successful in challenging restructures under this provision. We can see benefit in providing more clarity with this provision, namely the amount that is taxed is the retained earnings of the entities and specifically the capital gains of the entities should not be taxed, or sought to be taxed under avoidance provision. We would be happy to discuss further.

Conclusion taxing the sale of shares

4 Conclusion:

a. These proposals should not proceed for the above reasons

Determination of a company's ASC and available capital distribution amount (ACDA)

5 There are two proposals

6 **Option one**: Require the amount of ASC and the capital gain amount to be determined annually and reported to Inland Revenue.

7 **Option two**: Require taxpayers to record the information to evidence that they have calculated the dividend amount correctly (with Inland Revenue determining the amounts in the absence of reliable evidence), with no annual reporting requirement.

8 We believe it is best practice for taxpayers to quantify ASC and ACDA as and when transactions take place, namely on an annual basis. If there is to be annual reporting of this to the Inland Revenue, then this should be subject to the statue bar time restrictions. That is, the Inland Revenue should effectively have four years to dispute any such value placed on ASC or ACDA. This is our preferred position, namely annual reporting with statue bar applying to such reporting.

9 If the statute bar rules are not to be applied to the annual reporting, then we believe the current position, namely taxpayers self-assessing should continue.

Personal services attribution rule

10 It is also proposed to change the personal services attribution income to apply to businesses. The rule was originally designed to apply to quasi employees who operate through corporate structures. The proposal is to expand this to apply to many SME businesses. No policy rationale is provided for such a drastic expansion of the scope of the personal services attribution rule. It is hard to conceive of any justification for a policy that would impose individual tax rates on the retained earnings of 1 or 2 person firms while not affecting larger firms. We know of no international precedent for such a regressive tax deliberately imposing tax penalties small firms.

11 Example 8 illustrates of the document stated (emphasis added) "there **might** also be an issue when a taxpayer that performs personal services has multiple customers.

> **Example 8: Personal services business with multiple customers**
>
> Bill is an accountant who is the sole employee and shareholder of his company, A Plus Accounting Ltd. The company pays the 28% corporate tax rate on the income from accounting services provided to clients and pays a salary to Bill of $70,000. **Any residual profits are either retained in the company or are made available to Bill as loans**.

12 An obvious conclusion from the facts is that Bill is using the retained profits to finance debtors (most accounting firms carry significant debtors), computers, furniture, and other fixed assets. We cannot see any policy issue with "Bill" retaining the excess profits in the company to provide funding of these assets. This is exactly the intended outcome from policy of having a 28% tax rate, namely a lower corporate tax rate for business profits that are retained for further investment.

13 We do not comment on the detail given there seem no policy rationale of the proposals.

14 The above example suggest that the profits may be advanced to Bill as a loan. There are comprehensive dividend rules to negate any tax benefit arising from such a structure of loans to shareholders. These comprehensive dividend rules have been a feature of the tax framework for a considerable period of time and there has been no suggestion they are not working correctly in removing any tax benefit. The tax benefit of the loan is not explained, neither is the application of

the deemed dividend rules. There is simply no basis to suggest a change is required due to the loan.

Conclusion personal services attribution rule

15 Conclusion

a. The proposal should not proceed.

Concluding comments

We are obviously happy to discuss our submission. Finally, we note the proposed discussion document is not consistent with GTPP. If GTPP were being followed, rather than a proposal as outlined in the Document, the document should have outlined the issues and concerns and then sought feedback whether a policy response was required and what are the possible responses.

Yours faithfully
Olivershaw Limited

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3 May 2022

Dividend Integrity and Personal Services Attribution
c/o David Carrigan
Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
PO Box 2198
Wellington 6140

Sent via email: policy.webmaster@ird.govt.nz

Dear David,

DIVIDEND INTEGRITY AND PERSONAL SERVICES INCOME ATTRIBUTION

General Comments

Deloitte welcomes the opportunity to comment on the Government's discussion document on Dividend integrity and personal services income attribution (the Discussion Document).

Overall, whilst we agree that limiting the ability of individuals to avoid the top 39% rate (or the second-highest personal income rate of 33%) is a valid aim, we do not support the measures proposed. The reasonings for our position are summarised below and relate to the proposals resulting in considerable overreach as compared with the problem statement and issues of horizontal equity. We include further specific discussions and examples attached as Appendices 1 - 3.

We are happy to discuss the details of our submission with Officials.

DIVIDEND INTEGRITY MEASURE

Summary of submission points

General Comments

- We believe that there is considerable overreach in the proposals when considered against the proposals' stated aim to prevent tax structuring to avoid the 39% tax rate. The proposals will result in retained earnings being taxed in the hands of the shareholder, irrespective of the fact that the earnings have not been distributed to the shareholder. In some cases, the taxable amount may exceed the gain made by the shareholder on the sale of the shares.
- The proposals disregard the fact that the retained earnings of a company belong to the company. Retention of earnings is a common and sensible business practice to facilitate growth and provide resilience to changing economic circumstances. Reinvesting earnings in a business is not structuring to avoid the 39% tax rate, even when there is a controlling shareholder.
- The effect of this proposal is tax on capital sale proceeds which is contrary to Government's commitment to not introduce a capital gains tax.
- Imposing a lump sum tax on taxing historical earnings in the year of sale, also does not align with the reality that profits are earned over time.
- The objectives of the Discussion Document could be achieved by using the START system to help enforce the existing anti-avoidance, dividend and fringe benefit tax rules and do not require new draconian, prescriptive and, in many cases, arbitrary rules. We have seen through external presentations by Inland

Revenue that the START system has significant data analytic capability and Inland Revenue should be able to use that system to identify taxpayers who appear to be acting in a manner which is motivated by the introduction of the 39% tax rate.

Conceptual Issues
- We disagree with the scope of work in tranche one of this wider project. Consultation would have been more effective to determine the reasons why companies retain income and whether they should be respected as corporate retained earnings or whether there might be limited situations where they should be attributed to shareholders.
- To the extent that a business is retaining income and that income remains in the company we don't see any mischief to be addressed. To the extent that the retained earnings of the company are accessed by the controlling shareholder (via loans or other means), then that is the area which warrants some further examination and the creation of clear rules if it is determined there is an issue which warrants a policy response.
- We believe that the notable increase in the imputation credit account (ICA) balances are likely to be because companies are being incentivized to invest in growth rather than short-term income as opposed to the Discussion Document's conclusion that dividends are not paid to shareholders to avoid higher tax rates.
- It seems from our discussions with Officials that the wider proposals applying to third party share sales are based on their views that all profits should at some stage be subject to tax in the hands of shareholders, notwithstanding the fact that in most cases reinvested profits will remain in the business and will never be distributed.
- We also believe that the proposal on inter-group restructuring is fraught with technical issues and ambiguities and is applied arbitrarily.

Proposed Changes:
- We submit that Part 1 of the Discussion Document proposals should not proceed. Instead Government and Inland Revenue resources would be better applied to codifying a more targeted dividend stripping rule to deal with the perceived current abuse in the context of associated party transactions if it is in fact the case that the existing rules are not sufficient to protect the tax base.

AVAILABLE SUBSCRIBED CAPITAL or AVAILABLE CAPITAL DISTRIBUTION AMOUNT TRACKING ACCOUNTS

Summary of submission points:
- While we agree that taxpayers should be maintaining records of available subscribed capital and available capital distribution amounts, we don't believe the administration and compliance costs created by requiring these accounts to be maintained and filed with Inland Revenue are justified. Collecting this information comes at a cost, and for a large number of taxpayers, that cost is not justified as they won't distribute capital amounts to shareholders.
- If it is decided that this information is filed, the information should be accepted by Inland Revenue and subject to the time bar.

PERSONAL SERVICES ATTRIBUTION

Summary of submission points:
- We submit that there is no compelling evidence that change is required to justify these proposals. We note that in our meeting with Inland Revenue Officials, no examples were able to be provided by Officials of this being a significant issue that required legislative change.
- These proposals will impinge on commercial behaviours concerning how small businesses are structured.
- We submit that more clarity should be provided on the scope of the income that could be attributed, the measurement of the threshold, and which assets will be captured.

Ultimately, we believe that these proposals do not align with policy objectives and commercial reality. What these proposals will do is burden already struggling small businesses with additional compliance costs, when in most instances there has been no tax motivated behaviour.

If you have any questions or would like to seek consultation from Deloitte directly on any of the above matters, please do not hesitate to get in contact.

Yours sincerely

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Robyn Walker
Partner

for Deloitte Limited (as trustee for the Deloitte Trading Trust)

Deloitte.

Appendix 1

Dividend Integrity

I. General Comment

We believe that the proposed Dividend Integrity measures are removed from the commercial reality of owning and operating businesses. Canvassing our experiences from dealing with companies, we can see a number of key reasons why the proposals are problematic.

1. The proposal goes significantly further than just discouraging people to structure around the highest personal tax rate and will impose significant taxes and compliance costs on companies and shareholders where personal tax rates are not a factor in their commercial decisions.

2. The proposals contradict the normal commercial practice of keeping retained earnings in a business to facilitate growth and expansion. Paragraph 1.11 of the Discussion Document states that:

   Inland Revenue analysed existing data it holds on 350 high wealth individuals (individuals and families with more than $50 million in net assets) and found that they used or controlled 8,468 companies and 1,867 trusts. For 2018, these 350 individuals paid $26 million in tax, while their companies and trusts paid $639 million and $102 million respectively, showing a significant amount of income earned through lower tax rate entities.

   The conclusion above does not recognise that growing businesses require working capital. This retention of profits is necessary to facilitate growth and is done by companies regardless of the owner's wealth. Hence, in most instances, profits are retained if it is in the company's interest rather than to respond to tax rate changes. It is noted that based on the data above, on average each high wealth individual is declaring income of around $240,000, if on average they are directly paying $74,285 in tax (it is unclear whether the data provided by Inland Revenue includes imputed dividends, but we assume it does not). This suggests to us that people are paying themselves a fair amount of remuneration for personal exertion, assuming they are working in their businesses.

   Further, introducing a new exit tax on shares, where none previously existed, will potentially dissuade serial entrepreneurs from divesting investments and starting new ventures. This is an issue when the government repeatedly says it wants to encourage these as a pathway to future prosperity.

3. The proposals introduce a new tax on capital sale proceeds by recharacterising some or all of an amount received from the sale of shares into a dividend (calculated by reference to retained earnings and imputation credit balances). This runs contrary to the Government's commitment not to introduce a capital gains tax as discussed in paragraph 2.5.

Some of the unintended consequences of the proposals highlighted above can be demonstrated through an example.

Example 1

A and B are married and have been running SolarCo for 30 years as a family business. They set up the company when solar technology was first becoming mainstream and continued to operate the business making moderate profits. Each year A & B would be paid salaries that were fair for work undertaken in the company, bearing in mind their desire to grow the company. Remaining profits would be retained to help

> the business grow, including funding investment into new technology, acquiring a building, and funding the cost of trading stock.
>
> In 2023, A and B are approached with an offer to buy SolarCo, on the basis that solar energy has soared in popularity and future earning potential has increased. At this time, A and B have retained earnings and an ICA balance. A and B will have a deemed dividend, and each will be taxed at 39%, despite the amount being attributed to 30 years of work.

The example helps illustrate that the main group that will be affected by these proposals will be family-owned companies. A significant majority of these companies are SMEs. These are people who have invested their time, energy, and sometimes all their assets to grow their businesses. The challenges faced by these companies are more pronounced now because of the impacts of COVID-19.

II. Conceptual Issues

A. Scope of Tranche 1 Proposals

Paragraph 1.17 defines the scope of Tranche 1 which "concerns dividend integrity and income attribution measures relating to the use of closely-held companies and trusts by high-income individuals." Additionally, tranche two will deal with trust integrity and company income retention issues,[1] while a possible tranche three could consider integrity issues for the taxation of portfolio investment income, such as Portfolio Investment Entity (PIE) taxation.[2] We disagree with how these proposals are being progressed in tranches.

We believe that tranche one should be better spent on evaluating the reasons which exist for companies to retain income. This would provide a better platform to evaluate potential tax reform to ensure that proposals sit with the policy objectives which are related to the 39% tax rate. It would also allow Officials to obtain information about, and understand the growth and productivity benefits that accrue from, companies not fully distributing/attributing profits to shareholders on an annual basis.

B. Insufficient proof to support the tax problem

The Discussion Document makes the following observations in par 2.23:

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

However, we believe that the analysis conducted was insufficient to conclude the above. This is because the rise in ICA balances could be attributed to other factors. For example, an alternative hypothesis is that companies are being incentivised to invest in growth (with productivity benefits) rather than short-term income for shareholders. Consequently, the proposals may result in a reduction in productivity gains or in investment (shareholders may be incentivised to take more earnings from the company on an annual basis to reduce the likelihood of a dividend on sale at higher marginal tax rates).

[1] Paragraph 1.18 of the Discussion Document.
[2] Paragraph 1.20 of the Discussion Document.

We also note that any increases in imputation credit accounts and/or increases in retained earnings could also be attributed to the COVID-19 pandemic, whereby businesses have a new appreciation of the need to maintain strong balance sheets. Businesses who have also benefitted from any form of COVID-19 business support from the Government have also been discouraged from passing profits through to shareholders in the form of dividends[3].

It seems from our discussions with officials that the wider proposals applying to third party share sales are based on their views that all profits should at some stage be subject to tax in the hands of shareholders. Officials appear to have philosophical issues with shareholders receiving an untaxed capital gain in situations where a purchaser uses a holding company and can potentially extract retained earnings at a later stage without a tax impost. While that might be the case to some extent, in most cases reinvested profits will remain in the business and will never be distributed.

After discussing what issues arise on the scope, premise, and nature of the problem statement, we now turn to some operational issues of the proposal.

C. The Discussion Document's Proposal

The Discussion Document proposes the following in paragraph 1.29:

> *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.*

We will discuss the potential issues with such a proposal under two sections: related party sales and non-related party sales.

D. On related company sales

The general rule proposed involves recharacterising share sales as dividends in the hands of the selling shareholder, with the quantum of the dividend determined with reference to retained earnings and imputation credit account balances.[4] We first look at share sales between related parties. We refer to Example 5 in the Discussion Document of Pepperidge Profit Accumulating Biscuits Limited (PABL) to illustrate the operational issues that may arise.

1. There seems to be a risk of double taxation in the case of PABL. In Example 5, the Discussion Document claims that the proposals will prevent double taxation in the event of liquidation since the deemed net dividend (gross deemed dividend less deemed imputation credit) has already been treated as a dividend. However, we believe that there is still a potential for significant double taxation here.

   The foreign shares here is an example of double taxation. The tax rules have been designed to tax the foreign income in a particular way, which taxes only $250,000, not $300,000. However, these rules then tax the remaining $50,000 of income. This would not be the outcome for a look-through company or partnership.

[3] "We are reviewing the accounts of our customers who received one or more Resurgence Support Payment (RSP). The review is to make sure customers met the eligibility criteria and used these payments in line with the RSP terms and conditions. If we find your client was ineligible or has passed the RSP through to the business owners, shareholders, partners, trustees or other members of the business, or used the RSP for personal expenses, we may act to recover these payments." Source: https://www.ird.govt.nz/updates/news-folder/resurgence-support-payment-review-underway
[4] Paragraph 3.1 of the Discussion Document

In Example 5, Paul is being taxed entirely at the 39% tax rate despite the profits being accumulated over 15 years, many of which the top personal rate would have been 33%. This approach will result in punitive over-taxation.

2. The proposals need to provide more guidance as to who could be associates in such transactions. Paragraph 3.23 states that:

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

   The lack of definition of who could be associates can cast a wide net to varying degrees of organisational and familial relationships. The association rules will treat family members within 2 degrees of blood relationship as a single person under these proposals. With all due respect, family arrangements can be complex and there are a number of non-tax reasons why family members may want to exit family businesses.

   We also note it will need to be clear what family member shareholders should be aggregated to determine if a company is closely controlled. For example, in Example 5, if PPAB had three additional shareholders Penny (Peter's sister), Petra (Patty's sister) and Pedro (Petra's son), while Penny and Petra are each within 2 degrees of blood relationship with Peter and Patty, they are only within 3 degrees of connection to Paul and Pam; likewise, Pedro is associated to Petra, but is only within 3 degrees of relationship to Peter and Patty, 4 degrees to Paul and Pam and 5 degrees to Penny; so should Penny, Petra and Pedro's shareholdings be factored to when determining whether Paul's share sale is caught by the rules?

3. The proposal should also clarify what transactions could be captured in this rule. As noted above, in our discussions with Officials' they have indicated there is more concern where there are holding companies introduced in a manner that could allow value to be extracted from the group tax free. As such, it's unclear whether there are issues with the genuine sale of businesses between family members where no holding companies are created or are involved (or holding companies are introduced using a share for share exchange).

E. On non-related party sales

The Discussion Document clarifies that the dividend recharacterisation rule extends to sales to unrelated companies and individuals as per paragraph 3.15.

> *It is proposed that a dividend recharacterisation rule may be applied to Scenarios A, B and C. All scenarios have the same consequence for the seller, although they have different consequences for the buyer. It seems appropriate that the shareholder who owned shares in a company when the company earned income would be taxed on the income when shares are sold for a price that includes the value of the company's retained earnings. Failure to tax the retained earnings component of the sale price would also allow deferral of the top-up tax to be extended for a potentially lengthy period.*

In the context of third-party transactions, we do not believe a problem exists. Sales of companies to third parties are almost always priced on a 'debt-free, cash-free' basis, with typically minimal cash transferring as part of working capital. What the rule will tax then in third party transactions, is not profits retained in cash, but profits reinvested in the assets of a business, a point already discussed above. Further by calculating the taxable income with reference to imputation credits may result in the taxable income exceeding the maximum legally permitted dividend that the shareholder could have received.

We note that the application of these rules to non-related party sales creates practical issues, such as determining retained earnings balances given there is a 364/365 chance that a transaction will not occur on a companys' balance date.

Distortion of Merger and Acquisition Activity

We submit that the proposals in the Discussion Document will also distort commercial Merger and Acquisition (M&A) activity. Below are some examples of how the rule may distort or influence behaviours in the M&A space.

- The rule will be problematic for 'locked box' deals. Profits earned between the locked box date and the completion date economically belong to the purchaser, but will be taxable for the seller, not reflecting the economics on a locked box deal.

- We see that this rule will likely apply to all sales of profitable companies by private shareholders and will add complexity and compliance costs every time. Hence, we do not support the extension of these rules to unrelated party sales because besides being an overreach, this will also distort M&A activity.

- The proposals will also encourage corporate investors to acquire 100% of acquired entities to ensure that they are able to access the wholly owned group inter-corporate dividend exemption in the event that they are deemed to have received a distribution of un-imputed retained earnings on disposal of a controlling interest. This could have a negative impact on capital markets.

Inequitable outcomes

The proposals in the Discussion Document will also result in inequitable outcomes that may undermine the integrity of the tax system. Below are some worked examples that could illustrate these issues.

- If a business is owned 51:49 by two shareholders, only the 51% shareholder would be subject to tax under this rule. In a second example, if a business owned 49% by two unrelated shareholders and 2% by an employee, the rule would not apply at all. This has the potential to result in materially different tax outcomes for shareholders in similar positions.

- A foreign-owned company sells out its shares to local management. Five employees own the company 20% each. Over time, several shareholders progressively sell out their shares to the remaining shareholders, until there are two shareholders left owning 50% each. The first three shareholders have no tax consequences of their sale assuming they had a capital account investment. However, when either of the final two shareholders wants to leave, they could trigger the application of these rules as they are now controlling shareholders[5]. Depending on how control is defined, those shareholders will have a tax obligation in relation to 50% of the retained earnings and/or ICA balance relating back to when the company was first established. This is considering that some imputation credits may have been forfeited during prior shareholding changes.

- The proposal will result in inequitable outcomes for companies that have been profitable but have losses carried forward at the time of sale. For example, if Business A makes $100 in year 1, it pays $28 tax and has $72 of retained earnings. In year 2, Business A makes a $100 loss. Overall, Business A has made $0 economic profit. On sale, the shareholders of Business A will be deemed to receive a dividend of $100 ($28 imputation credits / 28%), despite not having made an overall economic profit.

[5] We note it is not completely clear from our correspondence with Officials whether the rules would apply only to "greater than 50% shareholders" or to "50% or greater shareholders"; at a minimum, if there was only one shareholder left in this example, that person would have a tax liability on exit that no other shareholders face

- Capital losses are also not reflected in the outcome of these proposals. For example, Business C buys Business D for $1 million market value. Business D makes $100,000 profit, pays tax, and does not distribute dividends. A pandemic impacts the company and Business C needs to sell. Subsequently, Business C is able to find a buyer willing to buy Business D for $900,000. Business C does not make any gain (i.e. market circumstances mean the company value has actually decreased). Business C will have a dividend of at least $100,000 (being the imputation credit balance of $28,000 / 28%). However, Business C will still have tax on a dividend but without a recognition that they have made a capital loss.

F. Employee Share Schemes

Given the wide variety of structures used to transfer economic ownership to employees, we are concerned that the proposed rule could have unintended consequences for employee share schemes and the (non-tax) benefits they provide. Consideration should be given to excluding transfers of shares to employees from the rule to avoid creating a barrier to their introduction (through tax cost or complexity).

G. General corporate structuring

The rule will apply to internal restructures or sales of shares but with added complexity. Example 7 in the Discussion Document suggests the purchasing company will be the entity deemed to pay the dividend, rather than the acquired entity with a second potential dividend being deemed paid by the acquired company. There will be a host of compliance issues to work through, even for the most basic restructures, and this again will mean additional compliance costs.

We submit that there needs to be clear guidance to explain when corporate restructuring can take place without triggering tax liabilities.

H. On succession planning

The Discussion Document does not include any guidance on how the rule should apply to the transfer of shares on death or on the settlement of a trust. Consequently, it is unclear whether these would trigger a tax cost. Therefore, we submit that more consideration would need to be given to these matters.

III. Our Proposed Changes

We acknowledge the concern in the proposal when there are transactions between associates which are structured to avoid taxes. However, the wider proposals cast a wide net and capture a wide range of shareholders who are not engaging in the types of activities the Discussion Document is trying to prevent. Additionally, there is already a targeted anti-avoidance rule which prohibits this. The Discussion Document states that:[6]

> *Dividend stripping arrangements are mostly governed by anti-avoidance legislation. Such legislation can be complex to administer and costly to litigate.*

However, with a targeted scope and clear guidance, these anti-avoidance rules could be more simple and more cost-effective than the proposals contained in the Discussion Document. We would be interested in understanding what information gaps currently exist and whether there is existing data in the START system which could help Inland Revenue identify potential dividend stripping transactions for review,

Finally, we submit that if there are any changes to the scope of the proposal, more consultation should be undertaken on the revised proposals prior to legislation being introduced. In such an event, we are more than willing to engage with Inland Revenue on this issue. Such consultation will ensure that the proposals align with commercial practice.

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[6] Paragraph 2.7 of the Discussion Document.

Appendix 2

ASC and ACDA Tracking Accounts

I. The Proposal

Paragraph 1.29 states that:

> *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.*

II. Our submissions

We acknowledge and support the aim to have formal clarification that companies should maintain a record of their available subscribed capital (ASC) and available capital distribution amount (ACDA) if they wish to utilise these amounts. However, our preference is that these accounts be maintained by the taxpayer and not to be filed with Inland Revenue. This is because the formal collection of this data will impose compliance costs on both Inland Revenue and taxpayers for minimum purpose. This will be especially so if taxpayers are required to calculate/disclose their historical ASC balance (although we note this is not currently proposed).

If a taxpayer wishes to undertake a transaction which would use ASC or distribute a capital gain, then the onus should be on the taxpayer to substantiate the relevant balance. This is consistent with the position which Inland Revenue has already articulated in "OS 22/01 Available Subscribed Capital record-keeping requirements".

Inland Revenue should not underestimate the potential compliance costs involved for taxpayers in constructing and maintaining these accounts; particularly for large and complex groups of companies which have gone through restructures. We have experience in spending literally hundreds of hours to locate historic records to reconstruct ASC and ACDA balances. The time involved was a necessary cost for that particular taxpayer; but for many taxpayers they will never need this information.

While the Discussion Document notes at paragraph 5.12 that as a transitional measure existing companies would not be required to reconstruct existing ASC / ACDA balances, it begs the question of what the point would be of applying these rules to existing companies at all – it would be "ultimately pointless" as the account balances would be meaningless; and if filed with Inland Revenue they would be incorrect. In addition, some current year transactions (i.e. a share for share exchange) require determination of a historical ASC balances in order to determine the amount of ASC arising for the current year transaction.

Our preferred order of outcomes would be:

1. No new rules. All companies are made aware of the onus of proof requirements under OS 22/01.
2. Newly incorporated companies after enactment of the rules are required to maintain records of ASC and ACDA. Records are not filed with Inland Revenue. Taxpayers have the option of not holding contemporaneous records at their discretion. Inland Revenue undertake to not request ASC/ACDA records unless the taxpayer has undertaken a transaction which utilises one of these amounts.
3. As above, but existing companies are required to maintain a record of ASC/ACDA transactions after date of enactment of the rules.

In the event that taxpayers are required to lodge these accounts with Inland Revenue, we submit that the Commissioner's ability to challenge a return to be subject to the time bar. This is contrary to what paragraph 5.6

proposes, whereby it states that "the Government does not propose placing a time limit on the Commissioner's ability to challenge a return in relation to the ACDA and ASC memorandum accounts."

Lastly, we note that if employee share schemes are created, tracking these accounts will be burdensome to the taxpayer. Therefore, consideration must be given in such scenarios; in particular whether businesses can opt to not monitor and document relatively small ASC amounts on a real-time basis (particularly where there is low likelihood of the taxpayer ever seeking to return the ASC to shareholders) with the detail of these amounts being able to be determined and included at a later date if the ASC is to be utilised.

Deloitte.

Appendix 3

Personal Services Attribution

I. The Proposal

Paragraphs 1.29 – 1.30 propose:

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

II. Submissions

We make the following submissions

- We note that the scope of the personal services attribution rule is proposed to be materially widened. The expansion of these rules will mean that a large portion of small businesses in New Zealand will need to attribute business earnings to owners. This means that there will be a higher tax cost on the profits that are retained as working capital to grow the business. Again, as a recurring theme in this submission, we believe this is an overreach with an unintended consequence of reducing funds available for reinvestment in the business.
- We do not support these changes because there is no compelling evidence that change is required.
- Inland Revenue already has other mechanisms at its disposal to void any egregious arrangements where individuals are accessing cash from a business and not paying the appropriate individual tax on the cash received without resorting to changing existing rules.
- These proposals will introduce inappropriate distortions between services and other types of small businesses where some will be subject to tax at individual tax rates and others will be able to continue to benefit from the lower company tax rate.
- The proposals will create incentives for small businesses to amalgamate. For example, rather than three plumbers running separate businesses which are subject to the PSIA rule, the three plumbers may form a single company so the "[50%] one natural person supplier rule" cannot apply.

III. Threshold Issues

We also do not support the changes to the one natural person supplier test and the substantial asset threshold for the following reasons. Lowering the threshold from 80 percent threshold to 50 percent will distort behaviours in a commercial setting. For example, this will induce employers to go into a partnership rather than as a sole principal; and it will be very difficult for businesses to measure who's exertion the business income is coming from (will all small businesses be required to maintain timesheets to establish whether more than 50% of income is attributable to a particular individual?). We also submit that the substantial business asset thresholds are too high especially if it is set at $200,000 for businesses run by tradespeople or specialists.

Lastly, there must be more guidance on the following points:

- Whether all income will be attributed once the 50 percent threshold is exceeded;
- How such threshold will be measured; and

- How a luxury vehicle will be defined.

Overall, we do not believe these proposals align with the problem statement in the Discussion Document and will disproportionately impact small businesses and tradespeople in New Zealand.

Public.Consultation@ird.govt.nz 2 May 2022

Dear Sir/Madam

Submission on Dividend integrity discussion document

We refer to the “Dividend integrity and personal services income attribution” discussion document published in March 2022 (“Discussion Document”). Thank you for the opportunity to make this submission, and for allowing the small extension.

NZ Private Capital is the voice of private capital in New Zealand. Our members partner with businesses across every sector of the market to help them grow. Businesses backed by private capital investment make a significant contribution to growing the nation’s economy.

As the leading voice for private capital investment, we support our industry through advocacy on important policy issues, helping shape regulatory frameworks and encouraging members to contribute ideas and challenges that accelerate growth ambition.

Submission

NZ Private Capital considers that the ‘dividend integrity’ proposals in the Discussion Document should not be progressed. Alternatively, if they are progressed they should only be progressed as a targeted anti-avoidance rule that supplements the existing avoidance rules in place in the legislation. Our key submissions are as follows:

1. ***Existing avoidance law***

   New Zealand has strong general and specific anti-avoidance rules already in place which are likely to capture the vast majority of situations in which avoidance of the 39% personal income tax rate may occur.

   If additional specific scenarios are identified or envisaged where unintended avoidance of the tax base may occur, then such scenarios should be limited by well considered and specific legislative changes.

   A shortage of resources to investigate and/or litigate those instances where such avoidance may be occurring is not valid justification for introducing law which not only captures the intended scenarios, but many more and with unintended consequences.

2. ***Counterproductive to growth and productivity increases in great NZ businesses***

   With New Zealand’s productivity lagging behind many of its global or OECD comparators, reinvestment in great New Zealand businesses for improvement and growth in revenues, employment and scale should be encouraged, not artificially deterred.

   By adding an artificial tax effect (the deemed distribution of retained earnings) to the sale of shares in a company, the proposals will significantly complicate the investment and realisation of capital in New Zealand businesses.

Any policy that seeks to distort the growth agenda and potentially inhibit reinvestment in these businesses will only further slow NZ's drive for creativity and productivity increases and reduce ambition to create world-leading businesses with significant, exciting employment opportunities for our generations to come.

Business owners should be free to make rational decisions as to either reinvestment or distribution based on the opportunities available to the business.

3. Artificial and negative distortions created to NZ Inc

Furthermore, rules which create distortions and inappropriate incentives, should be avoided at all costs.

One specific outcome or consequence of the current proposals may be for New Zealand founders / owners of businesses to seek offshore investment and control of their businesses much earlier in their lifecycle.

This both disadvantages New Zealand based investors or collective investment vehicles in comparison to their foreign counterparts, but also means this Government would be encouraging value creation to be occurring more in the hands of foreign investors than it would its own country and investors, moving significant wealth offshore.

4. Multiple taxation of the same economic amounts

The proposals also have the perverse potential of taxing the same economic income multiple times.

Transactions in shares as opposed to assets occur for very legitimate commercial and legal reasons, and would rarely be tax motivated. The provision of ASC as a means of mitigating the taxing of the same economic income multiple times over does not work unless every such business sale occurs via way of an asset sale and liquidation. This does not reflect commercial reality. In most situations it is not commercially preferable to proceed as an asset sale due to the added complexities of transferring employees and assigning contracts / transferring assets.

We welcome any discussions you may wish to have with us on the matters raised below. Please contact either Brad Wheeler or Colin McKinnon.

Yours faithfully

Brad Wheeler
Chair – Policy & Regulatory Working Group
Email: s 9(2)(a)
Mobile:

Colin McKinnon
Executive Director
s 9(2)(a)

Graeme Olding

Barney Cumberland

Submission on changes to the personal services income attribution rule

As proposed in *Dividend integrity and personal services income attribution – a Government discussion document, Chapter 7*, and the associated regulatory impact statement available at https://taxpolicy.ird.govt.nz/publications/2022/2022-dd-dividend-integrity-psa.

Submission by: Richard Donnelly, Executive Director and Principal
Richard Donnelly Limited (NZ Company No. 8097581)

s 9(2)(a)

I am happy to be contacted to discuss the points raised below, if required.

Summary of Key Points and Recommendations

Under the status quo, the "80% one buyer" test in combination with the "80% one natural person supplier" test is a good proxy for a specific tax avoidance scenario. The qualifier that personal services would likely otherwise be supplied through a traditional employment arrangement is essential because it limits the application of the personal services income attribution rule to the only situation in which it makes sense. The proposed changes disconnect the rule from this qualifier and will dramatically broaden the range of businesses to which the rule applies. The changes will result in the revenue of all sole operator small businesses being treated as if that revenue were equivalent to the personal income of the related taxpayer. This is not a fair and reasonable solution to the perceived tax avoidance problem. Just because some such structures may have been established for the purposes of tax avoidance does not mean the Government can treat all such structures as if they are vehicles for tax avoidance.

The proposed removal of the "80% one buyer" test seems to rest on an erroneous assumption that company revenue and personal income are always the same thing. While this may be the case in specific situations where, were it not for the interposed entity, the tax payer would otherwise earn equivalent remuneration via a traditional employment arrangement (i.e., situations which are the target of the personal services income attribution rule as it is currently specified), it is not the case more generally. Company profits arising from the legitimate difference between input and output values should not be treated as personal income.

The proposed reduction in the threshold for the "one natural person supplier" test will result in profit arising from the collaborative efforts of more than individual being taxed as if they have been generated by one individual working alone. This is unfair and fails to recognise that revenue earned through collaborative working is not revenue that can be earned working alone.

I whole-heartedly disagree with the proposed changes to the personal services income attribution rule. The "80% one buyer" test should be retained and the threshold for the "one natural person supplier" test should remain at 80%.

General Comments

I do not agree with the proposed changes which shift the focus of the personal services income attribution rule from narrowly targeting taxpayers who are similar to employees, towards capturing a wider array of scenarios where an individual may use an associated entity as a conduit for selling their personal services to one or more customers.

The purpose of the personal services attribution rule, as it is currently implemented, is to mitigate the risk of tax avoidance in situations where "…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" (refer para 6.3 of the discussion document; emphasis added). This is a specific scenario where there is a credible risk that the only reason for supplying personal services via a separate legal entity rather than a traditional employment agreement is to avoid personal income tax. The current "80% one buyer" test and the "80% one natural person supplier" test are, in combination, a good proxy for this situation.

The qualifier that personal services would likely otherwise be supplied through a traditional employment arrangement is essential because it limits the application of the personal services income attribution rule to the only situation in which it makes sense – i.e., where it is likely that the related tax payer is deliberately avoiding tax that would otherwise have to be paid on their salary or wages as an employee.

The effect of the proposed changes will be to disconnect the personal services income attribution rule from this qualifier and will dramatically broaden the range of businesses to which the personal services attribution rule applies, many of which will be businesses supplying services of a type and in a manner which could not be achieved through a conventional employer/employee arrangement. As a result, the changes will render the rule effectively arbitrary in its focus on personal services. To wit: How is a small personal services business that supplies more than one client and which is "mostly" (>50%) reliant on the efforts of a single individual any different from a tax avoidance perspective to any other small business that is similarly reliant on the efforts of a single individual? The proposed changes will mean profits generated by sole operator personal services businesses will be treated differently from corporate profits more generally just because they are attributable "mostly" to the efforts of a single person. This is wholly unreasonable.

The proposed changes to the personal services income attribution rule are motivated by the Government's observation that there has been a significant increase in structuring activity since the introduction of the 39% personal income tax bracket. While it seems reasonable to assume that some of this activity is for the purpose of tax avoidance, the proposed changes will also impact small businesses that were legitimately established for asset protection and were set up and operating before the introduction of the 39% tax rate was announced. This is unfair.

The proposed changes are also motivated by the Government's desire to find a solution to the perceived tax avoidance problem that does not require the Government to do the hard work of actually proving that particular business structures have been adopted specifically for the purpose or effect of tax avoidance. Paragraph 32 of the regulatory impact statement notes, "Inland Revenue's general experience has been that, when there is a specific and identifiable situation where avoidance is a concern, it is usually better to have a specific rule that addresses the concern than it is to rely on the general anti-avoidance rule." The proposed changes to the personal services income attribution rule do not achieve this. In fact, they achieve the opposite – they move a specific and narrowly framed rule that targets a specific and identifiable tax avoidance situation to a blunt instrument that will broadly target all sole operator small businesses. For these changes to be justified, surely the Government should have to demonstrate that the majority of small business structures that fall within scope of the revised rule can reasonably be suspected of having been set up primarily for purpose and effect of tax avoidance. At the moment the Government is merely surmising that some of them have been.

In my view, the proposed changes to the personal services income attribution rule amount to lazy policy. Beyond identifying that structuring activity seems to be occurring, neither the discussion document nor the associated regulatory impact statement provide any substantive analysis or quantification of the scope, magnitude, or characteristics of the real-world problem that could be used to inform the development of specific policy targeting that problem. Nor do they provide any analysis or quantification of the impacts of the proposals – which will be significant on those real businesses covered by the proposed changes. The proposals amount to a "tax grab" on small businesses, apparently justified by nothing more than hypothetical supposition. To the extent that tax avoidance is occurring in small businesses, it is ultimately a function of what those businesses are paying for their inputs and how the profits are returned to the shareholders. The proposed changes to the personal services income attribution rule do not address either of these things.

Do you agree with the proposed removal of the "80 percent one buyer" test? Why/why not?

I do not agree.

With reference to Para 6.3 of the discussion paper, the purpose of the personal services attribution rule is to mitigate the risk of tax avoidance in situations where "…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." The "80% one buyer" test, in combination with the "80% one natural person supplier" test, is a good proxy for this situation.

Removing the "80% one buyer" test would mean that the personal services attribution rule will apply to consultants and contractors who work for multiple clients in situations far removed from the traditional employer/employee scenario. In my case, I work as an independent consultant and would normally expect to work for several clients in any given year. With reference to the IRD's own guidelines (https://www.ird.govt.nz/roles/employees/self-employed-or-employee), I am self-employed. The nature of my work is such that I am engaged to solve specific problems or provide certain advice to my clients. This work would not and could not otherwise be done as an employee of the client organisations.

The justification for the proposed change to the "80% one buyer" test seems to rest on the assertion that, irrespective of the number of clients served, "the taxpayer is performing work and being paid for it – the entity is effectively just a conduit for the taxpayer's income-earning activity. Consequently, the taxpayer should be taxed on their fee income at the applicable marginal rate." (Refer para 6.14 of the discussion document). The embedded assumption is that the individual would receive the same level of remuneration regardless of the commercial structure under which the services are provided. This is not the case and conflates two different values – the value of the inputs vs the value of the outputs.

To illustrate, consultants in my field with an equivalent level of experience can expect to charge out at anywhere from $180 - $300 per hour depending on the nature of the client, the work, and the commercial arrangements. My average hourly rate invoiced for FY21/22 was $220 per hour. Assuming an average level of productivity, I could expect to generate average revenue of ~$300,000 per year in direct billings, which reflects the output value of my services. As a salaried employee, however, my expected income would be less. In my case, prior to commencing as an independent consultant I was employed on a salary of ~$160,000 per year. Through my company, I currently withdraw the equivalent of a salary of $180,000 which I believe is in line with market rates for the services I provide and the level of salary that I could expect if I was to seek employment with another company. This reflects the input value of my services.

It is expected that a company (whether my own or another) that sells my services should profit from the difference between input and output values. Those profits are not personal income and should not be taxed as such until such time as they are returned the shareholder(s). The proposed removal of the "80% one buyer" test would, however, see the profits of my company treated as my personal income even though I could not otherwise realise income at that level through traditional employment arrangements and the services I provide would not otherwise be provided through such arrangements. If I provided the same services via employment with a larger consultancy my personal income would be equivalent to what I currently draw from my company, but that company would not be subject to this tax penalty on the resulting profits. It amounts to the Government deciding how the profits of my company should be taxed for no other reason than I am a sole operator. This is wholly arbitrary, unfair, and unjustified.

The “80% one buyer” test should be retained.

Do you agree with the suggested decrease in the threshold for the “80 percent one natural person supplier” test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?

I do not agree.

With reference to Para 6.3 of the discussion paper, the purpose of the personal services attribution rule is to mitigate the risk of tax avoidance in situations where “…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.” The “80% percent one natural person supplier” test, in combination with the “80% one buyer” test, is a good proxy for this situation.

Reducing the threshold for the supplier test would mean that the personal services attribution rule will apply to small businesses where the services are supplied by and are fundamentally the product of the collaborative efforts of more than one individual. This fails to recognise that revenue earned through collaborative working is not revenue that can be earned working alone. In my case, I work as an independent consultant but often engage sub-consultants to support my service delivery. While my personal services account for more than 50% but less than 80% of my company’s revenue, the services that I provide in conjunction with other consultants cannot be provided by me alone – it is the joint effort that provides the service and the benefit to the client. The proposed change in threshold would see profit resulting from those joint efforts being taxed as if I had earned it alone. This is wholly unfair and unjustified.

The threshold for the “one natural person supplier” test should remain at 80%.

Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?

No comment.

Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter?

No comment.

Do you consider the net income threshold should be increased from $70,000 per year to $180,000?

No comment.

From: Barry Robinson
To: Policy Webmaster
Subject: Dividend integrity and personal services income attribution
Date: Saturday, 7 May 2022 7:00:39 PM

Dear IRD.
I am a small business owner who will be massively affected by the proposed changes.
The last 2 years have been very tough, and the proposed changes will add another (very significant) burden.
Just reading it makes me very much more depressed, tired and demotivated.
I have read through the submission made by the NZ Taxpayers Union and I fully support their submission.
Please do not proceed with these changes.

Regards,
Barry Robinson

ACCOUNTANTS + TAX AGENTS INSTITUTE OF NZ

5th May 2022

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

Tēnā koutou

Dividend integrity and personal services income attribution

The Accountants and Tax Agents Institute of New Zealand (ATAINZ) is an Inland Revenue Approved Advisor Group of registered tax agents.

Membership is restricted to people with suitable qualifications and/or work experience relating to accounting and/or tax matters.

ATAINZ's objects include:

1. to represent ATAINZ members;
2. to advance and foster tax knowledge amongst members;
3. to further and develop good business practice amongst members;
4. to maintain the highest standards among ATAINZ members by restricting membership to suitably qualified people; and
5. to consider, initiate, debate and make submissions on New Zealand tax laws.

At present ATAINZ has more than 400 members acting for approximately 150,000 taxpayers. These include business owners, self-employed, partnerships, companies, investors, salary and wage earners, superannuitants, rental income investors, farmers, estates and trusts.

This submission has been prepared after feedback from members and from discussions between Inland Revenue officials and Terry Baucher, our Submissions Co-ordinator. The focus of our submission is on those parts of the proposals which we consider most affect our members and their clients. Our submission begins with some general commentary on the discussion document followed by our responses to the specific questions asked.

General commentary on proposals

We are concerned at the scope of the proposals in Parts I and III of the discussion document which we consider will fall disproportionately on small businesses which make up the majority of our membership and our membership's clientele.

We accept the introduction of the 39% income tax rate requires integrity measures to ensure its broad application, however we consider the proposals in Parts I and III appear to be based on an assumption that the use of legal entities such as companies and trusts is largely tax driven. We do not agree. The use of companies for trading is widely accepted across New Zealand for reasons other than taxation.

The marketplace is suspicious of any trading entity that is not a company – even more so if the company is not GST registered. Company structures are easily understood and through the Companies Office register it is an easy process to cross check directors and shareholders.

Furthermore, the limited liability protection that a company offers makes very sound business sense. Used in conjunction with trusts, owners have asset protection which allows them to operate without fear of losing personal assets.

Owner/operator companies, such as electricians, plumbers and other trades represent a significant proportion of small business enterprises. The low cost of entry into business is a deliberate design feature of the New Zealand economy. The proposals potentially jeopardise expansion of the SME sector.

The personal services attribution proposals could mean owners of businesses in the same industry might be subject to very different tax treatment simply because of how one or two employees are utilised. We consider such an outcome would do little for the public perception of the integrity of the tax system.

Overall, we believe the proposals unfairly target the SME sector.

Although the discussion document suggested that attempts to circumvent the 33% rate are already occurring it provided little evidence of the potential amount of tax involved. In particular, we have not seen sufficient evidence to support the need for the proposals outlined in Part III of the discussion document.

We consider Inland Revenue has existing tools such as applying the prescribed rate of interest to overdrawn shareholder/proprietor current accounts which it can use to counter perceived avoidance.

If there is a concern regarding the excessive retention of earnings and imputation credits, we consider a better alternative would be to introduce a limit on how long imputation credits may be retained without being distributing. For example, such a time limit could be ten years from the end of the imputation year in which the credit first arose.

In relation to employees acting as contractors, we consider the existing rules should be sufficient to counter potential abuse and non-compliance. Inland Revenue could deploy further resources into investigating whether "contractors" are in fact genuine contractors or de-facto employees.

Responses to specific questions

Part I

Question	Submission
Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?	Not in every circumstance
Should the scope of the proposed recharacterisation rule cover all of scenarios A, B, or C, or only one or two of these scenarios?	We consider it should only apply in scenario A (that is one involving related parties). We consider extending the rule to cover transactions carried out at arm's length between unrelated parties would be excessive and could potentially hinder the ability of companies to raise capital through introducing new shareholders or retain/induce staff through employee share schemes.
Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?	Recharacterisation is appropriate in so far as it applies to related party transactions
Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?	On the basis that the proposals are effectively targeting undistributed income this basis is broadly acceptable.
What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two), and which of these approaches do you prefer? Is there an alternative approach you would suggest?	We are not sure either of the proposed methods adequately deal with issue of excess imputation credits relative to retained earnings because of losses incurred subsequent to when imputation credits arose.

Question	Submission
Do you agree with the proposed approach (outlined in Example 3) for calculating dividends and ASC adjustments for corporate groups?	No comment, however, the example illustrates the complexity of the proposals.
Is the approach outlined in Example 4 for a sale of one controlled company to another (existing) controlled company (potentially generating a deemed dividend from both companies) correct conceptually?	No comment, however, it seems a somewhat unusual scenario.

Part II

Question	Submission
Whether the proposed transitional rule is appropriate.	Yes
Whether the Commissioner should be able to reopen a return and on what basis	Not for companies subject to transitional rule
Whether the proposal strikes an appropriate balance between compliance costs and tax integrity.	We consider the approach is reasonable. We think it likely much of this information is already being recorded permanently.
Whether the ASC and ACDA memorandum accounts should be reported in annual returns.	We recommend triennial reporting.

Inland Revenue
5th May 2022

Part III

Question	Submission
Do you agree with the proposed removal of the "80 percent one buyer" test? Why/why not?	No, we are not convinced there is clear evidence of mischief which requires the change
Do you agree with the suggested decrease in the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?	No, as noted above we consider this an unnecessary expansion of the rule. We are also concerned it would introduce confusion for smaller businesses as to where the boundary arises.
Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?	We consider the suggested thresholds are too high and overstate the impact of inflation since 2000.
Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter?	As noted above we consider the suggested thresholds are too high, and suggest it should be a maximum of $125,000.
Do you consider the net income threshold should be increased from $70,000 per year to $180,000?	Yes, aligning with the threshold at which the 39% commences seems appropriate. Would also minimise the compliance burden for SMEs

Please contact either of ourselves, or Terry Baucher, our Submissions Co-ordinator, if you have any queries regarding this submission.

Yours sincerely

s 9(2)(a)
[redacted]

Gary Upson
Chief Executive Officer
ATAINZ

s 9(2)(a)
[redacted]

Richard Abel
Chair
ATAINZ

From: Kevin Sharp
To: Policy Webmaster
Subject: We are opposed to proposed changes to raise taxes for small businesses
Date: Friday, 6 May 2022 1:12:05 PM

Its hard enough now to make ends meet.
Regards
Kevin Sharp
Sharp Planning Solutions Ltd

From: Rhys Ellery
To: Policy Webmaster
Subject: more business taxes!?!
Date: Friday, 6 May 2022 2:31:54 PM

External Email CAUTION: Please take CARE when opening any links or attachments.

Dear IRD,

Have you gone mad? More business taxes coming???

I've got a business that i've been steadily growing and all the while I have to keep dealing with new rules and regulations brought in by this government.

Now you're going to tax my business on retained earnings simply for trying to be successful, reinvesting and creating jobs!?!

This will probably be the straw that breaks the camels back and gets us to leave NZ for better shores.

There is no point building a business in a country that is seemingly intent on making things difficult.

Aussie or England seem much better places to be so here our business comes.

Regards
Rhys

Sent from my iPhone

PUB-035

From: Kathy Fray
To: Policy Webmaster
Subject: Big tax hike on small business
Date: Saturday, 7 May 2022 12:40:27 PM

Dear IRD Policymakers

We understand Inland Revenues proposes severely limiting which businesses will be eligible for the 28% company tax rate. Eg, A business owner who provides more than 50% of his or her company's services would now be denied access to the 28% company tax rate, even if they have dozens of clients.

To add salt to the wound, big publicly-listed companies will be exempt from these tax hikes. But Inland Revenue are aiming for the kings but shooting the peasants!

For many business owners it will result in more tax payable than if there was a full capital gains tax.

This is all insanity gone nuts! Small business are the biggest employers in NZ.

It's crazy.

This is all incentivizing or best and brightest to leave NZ.

YOU CAN'T TAX A NATION INTO PROSPERITY!!

Kathy Fray

Midwife, Best-Selling Author & Award-Winning international private Maternity Consultant

Changing the world positively - one Birth at a time.

Kathy Fray's MotherWise resources: www.kathyfray.com

Intl Integrative Maternity HealthCare Org: www.iimhco.com

about.me/KathyFray

Maternity Expert Profile (for Press)

From: Peter Trewavas
To: Policy Webmaster
Subject: Proposed Tax Hikes
Date: Saturday, 7 May 2022 1:02:05 PM

Dear Sir/Madam,
I'm adding my two cents worth over your proposed tax hikes for small businesses. David Parker and the rest of his incredibly bad, out-of-touch Labour government lackies are obviously on a mission to kill one of the powerhouses of New Zealand's economy. Small businesses in this country are already staggering under the weight of increased holidays and sick leave for their employees plus multiple increases in the minimum wage, all in the middle of a pandemic !
That's madness on its own let alone this new threat. This new tax will only push businesses already under stress, right over the edge and into the abyss of bankruptcy and put anyone contemplating starting a new business right off the idea.
PLEASE - don't go there.

Regards,
Pete Trewavas
Coster Properties Ltd
Nelson

From: Marcia Prince
To: Policy Webmaster
Subject: Changes to the28% company tax rate.
Date: Monday, 9 May 2022 11:10:46 AM

Dear Sirs,

As a one man company I will be forced to close my business if this new tax rule comes into play.
I am already struggling under the current tax bills what with Provisional, company , GST, ACC Regional fuel tax, Rucs as well as regular compulsory license fees and site safe fees. When will it stop? It doesn't pay me to be an entrepreneur if you keep taxing us to within an inch of our lives .

Please think before you burden the little man rather than the big companies that seem to be riding the tax wave with impunity .

Regards
Troy Prince
TroMar Maintenance and Electrical Services Ltd.

From: Grant Collingwood
To: Policy Webmaster
Subject: Dividend integrity and personal services income attribution
Date: Monday, 9 May 2022 12:43:53 PM

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I recently became aware of the proposals in discussion with regard to Personal Services Income Attribution. I found this after the closing date for submissions. Although the date has closed, I may have been able to find the time to read and understand this, however, I am busy working in my Small Business. I only became aware of the full implications when it appeared in the media.

I feel a great concern about the changes discussed. Partially how the changes could potentially affect our business, but also, the changes will affect plumbers, electricians, painters, builders and any other small business people that we all use for maintenance and repair work around our homes. These proposed changes will undoubtedly result in the costs of these contractors to increase. Or, potentially go out of business. It is so hard to find people to do work these days, and this would make the situation worse.

Also, the changes are so complex, that compliance could cause a huge amount of small business time and money.

I understand that changes were required to prevent high income earners ($180k etc) avoiding tax, but you would be hitting the low income earning businesses. This was actually in the proposal when it refers to the $70k as being included.

As small businesses, we have been hit hard due to Covid disruption, and often the strict measures in the recovery packages did not help. The changes proposed in this document would result in an unprecedented stifling of recovery.

My request is to please reconsider, and limit changes to the intent needed, which is to prevent the top income earners from avoiding tax.

Kind Regards,

Grant Collingwood
Support Manager
Ctas NZ Ltd

s 9(2)(a)

Not in scope

From: Karen Manson s 9(2)(a)
Sent: Monday, 9 May 2022 9:12 PM
To: Policy Webmaster
Subject: Submission on dividend integrity and personal services income attribution

C/- Deputy Commissioner, Policy and Regulatory Stewardship

Submission on dividend integrity and personal services income attribution

The government discussion document ("the Document") proposes three changes. This submission is on two of the proposals:
a. Shareholders being taxed on the sale of shares in a company to the extent that the company (and its subsidiaries) has retained earnings b. The changes to the personal services company rules that effectively remove when small business can use the lower corporate tax rate.

We strongly oppose both these proposals as in effect, they amount to additional taxes on small businesses. The case for such ad hoc measures being necessary to buttress the 39% income tax rate is not made in the Document.

Instead, these measures would prevent small businesses from using retained earnings taxed at the corporate tax to invest in the firm's plant and machinery and other necessary business assets.

Taxing share sales on the gross value of the underlying retained earnings, in effect, deems all such earnings to be distributed to the vendor shareholder at the time of the share sale. However, the earnings are still invested in the firm funding business assets. There is no justification for deeming this to be income of the vendor shareholder when it is still invested in the business.

Applying this rule to all controlling shareholders including shareholders who "act together" would mean the rule would apply to most family businesses. In effect they are then denied the 28% company tax rate for reinvested profits that other larger businesses have.

The current personal services attribution rule deems the income of a company that is in effect merely the single shareholder's employment income to be income of that shareholder and so is taxed at individual rates not the company rate. For the rule to apply currently:
a. 80% of the firm income must come from one client; and

b. The owner must generate 80% or more of the firm profits; and

c. The firm must have less than $75,000 in business assets.

The proposal is in effect to apply this rule to many family businesses that have fewer than two or three employees and business assets less than $150,000 to $250,000. This would cover many tradies and small contractors. They would be denied the ability to finance assets out of profits taxed at the 28% company tax rate. We say that is unfair and wrong.

Together, these proposals disproportionately increase taxes on small businesses and in effect represent a substantial break from the Labour Party's pre-election promise to not introduce any new taxes beyond those in the Party's election manifesto.

Regards

Peter and Karen

chapman tripp

9 May 2022

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

From: Graeme Olding
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by email

SUBMISSIONS ON DIVIDEND INTEGRITY AND PERSONAL SERVICES INCOME ATTRIBUTION DISCUSSION DOCUMENT

1 Thank you for the opportunity to provide submissions on 'Dividend integrity and personal services income attribution — a Government discussion document' (the *Discussion Document*). Our submissions in response to the Discussion Document are set out below.

Key submissions

2 The stated rationale for the proposal to tax undistributed retained earnings by deeming a dividend to arise when shares are sold (the *Dividend Proposal*) is to counter the retention of after-tax profits by companies in order to avoid paying tax at the top marginal tax rate (i.e. by realising the value of after-tax profits through selling capital account shares instead). In our view:

2.1 the Dividend Proposal goes well beyond an integrity measure or avoidance rule. It is not targeted at individuals who are on the top marginal tax rate. Instead it represents a fundamental change to the tax system. The Dividend Proposal would effectively derecognise capital gains arising to equity holders and ignore the commercial realities that taxpayers face when selling shares; and

2.2 there is a fundamental issue with the way officials have presented the Dividend Proposal as an integrity measure without discussing the significant change in underlying tax policy that it represents.

3 If the Dividend Proposal is targeted at companies not paying dividends, officials should consider whether this can be adequately addressed by existing anti-avoidance rules (including sections BG 1 and GB 1), or whether a new specific anti-avoidance rule may address officials' concerns. Further guidance in relation to existing anti-avoidance rules, or the introduction of a new specific anti-avoidance rule could address officials' concerns with the integrity of the 39% tax rate without significantly altering the way in which companies are taxed. For example, it may be appropriate for Inland Revenue to update the guidance published in Revenue Alert RA 18/01 Dividend Stripping now that wedge between the corporate tax rate and the top marginal tax rate has increased from 5% to 11%.

4 The Discussion Document notes in various places that the Government has declined to introduce a capital gains tax. In our view, this policy decision by the Government should be respected and the policy response from the Department should not be to seek to legislate away the existence of capital gains.

5 This attempt to derecognise capital gains through the Dividend Proposal results in sub-optimal outcomes when compared to a capital gains tax, and because it seeks to derecognise a real-world capital gain is incoherent with other existing tax rules. As a result, we anticipate it would be extremely difficult to ensure compliance and that introduction of the Dividend Proposal would have unintended consequences. Key design issues include:

5.1 the lack of rollover relief included in the Dividend Proposal;

5.2 the lack of a permanent loss carry back regime to operate alongside the Dividend Proposal (e.g. so that a company's ICA broadly moves **up and down** in tandem with accounting retained earnings in order to genuinely reflect the dividends a company could pay prior to sale); and

5.3 the lack of opening balances included in the Dividend Proposal (no attempt to mitigate possible retrospective effect).

6 If, notwithstanding our comments above, the Dividend Proposal were to be adopted, the scope of the rules must be narrowed so that:

6.1 deemed dividends are calculated by reference only to a company's ICA balance— otherwise a wider review of the appropriateness of shareholder continuity rules for ICA balance must be undertaken in tandem with the introduction of the Dividend Proposal, and the ICA rules would, in our view, require amendment with retrospective effect;

6.2 the rules operate on a go-forward basis only (i.e. transitionary rules ensure that historic retained earnings are not captured by the Dividend Proposal); and

6.3 the rules only apply to sales of shares by natural persons subject to the 39% tax rate.

Additional submissions

Should apply to 39% shareholders only

7 At paragraph 3.43 the Document suggests the Dividend Proposal should apply where shares in an operating company are sold by a holding company. The stated reason for applying the Dividend Proposal to companies disposing of shares is that, without such a rule, holding companies could be used to frustrate the Dividend Proposal. However, selling a company from within a corporate holding structure is not always relevant to the integrity of the 39% rate.

8 In our view, the Dividend Proposal must be much narrower in its potential application if it is to be properly understood and applied by taxpayers. Narrowing the scope of the rule to natural persons who would be subject to tax on the top marginal rate would achieve this.

Problems with quantifying deemed dividend

9 There are problems with quantifying a deemed dividend with reference to either: (i) grossed-up accounting retained earnings less non-taxable capital gains; or (ii) a company's ICA balance divided by the company tax rate. Imputation credits are not refunded when a company has made losses and so an ICA balance may bear very little resemblance to the actual retained earnings a company has available to distribute. Even more fundamentally, accounting income is not calculated in accordance with tax principles and we expect significant work would need to be done before the accounting concept of retained earnings could be used as a general starting point for quantifying any deemed dividends.

Problem with retrospective / unintended consequences

10 As an example, suppose:

10.1 **From January 2018 to August 2019:** Restaurant Co Ltd (*RCL*) is established by Original Owner and runs as a profitable business. RCL reinvests all retained earnings over this period, amounting to $300k.

10.2 **On 1 August 2019:** Original Owner sells RCL to New Owner.

10.3 **From 1 August 2019 to now:** RCL made pre-tax profits of $100k in FY20 and paid $28k in income tax. In FY21 and FY22 YTD RCL has made significant losses and New Owner is in the process of selling the business.

11 If New Owner sold RCL now and did not have an 'opening balance' to coincide with the introduction of the Dividend Proposal, New Owner would potentially be taxed on:

11.1 retained earnings that were attributable to Original Owner from January 2018 to December 2019; or

11.2 cash dividends that could have been paid, but were instead reinvested **and lost** of $72k.

12 In either case, neither RCL nor New Owner will necessarily have the funds to meet the tax payable in respect of New Owner's deemed dividend receipts. The potential for retrospective effect and unforeseen consequences must require that if the Dividend Proposal is adopted, it is only adopted prospectively.

13 Please let me know if you would like to discuss these submissions.

Yours faithfully

s 9(2)(a)

Graeme Olding

Partner