Tax Tips Alert | April 2022

39% tax rate integrity measures

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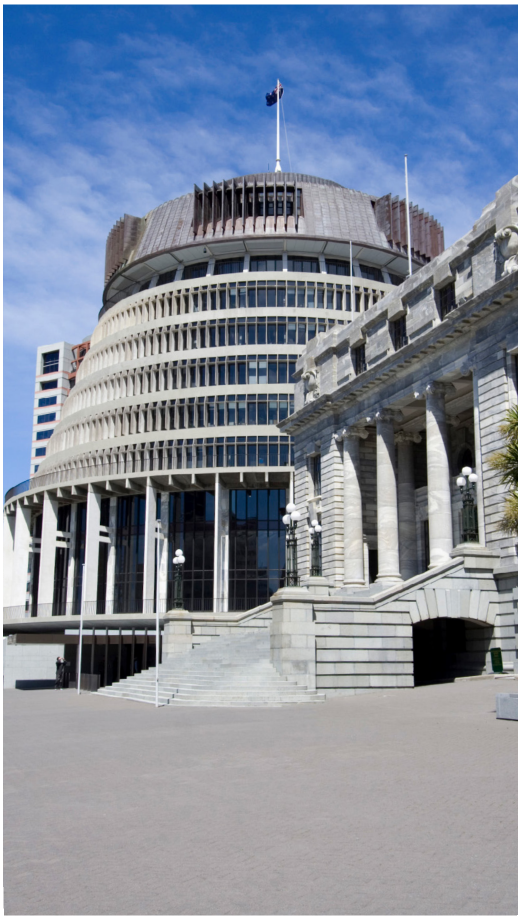
39% tax rate integrity measures

On Wednesday 16 March, the Government released a discussion document for consultation, with significant proposals that will impact thousands of taxpayers across New Zealand, including shareholders in companies and any individuals who operate small service businesses. The discussion document states that the motivation of the proposals is to ensure the 39% personal tax rate increase is effective in raising additional tax revenue, by reducing the circumstances where a taxpayer is able to avoid the new 39% personal income tax rate by diverting income through entities that are taxed at a lower rate.



The Government has made a commitment not to introduce a capital gains tax. As a result of closing out that option, it finds itself continually trying to push back the traditional capital boundary and entity based taxation in order to work towards its objective of improving the progressivity of the tax system. The proposed 39% integrity measures in relation to share sales represents one more step in that objective, intending to tax what is currently a capital gain.

Our key concern with this latest round of proposed changes, when combined with the other recently enacted tax changes, is the impact on the coherence of New Zealand’s tax system. A good tax system should be one that is relatively easy for the majority of taxpayers to understand and comply with. Common sense should go a long way to help someone work out their tax obligations – to a large extent horizontal equity should get us there. However, with these proposals, horizontal equity is being further eroded, resulting in a less coherent tax system which is increasingly hard for taxpayers to navigate.

The proposals

1. Deemed dividend on share sale

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). A "controlling shareholder" is one that, together with their associates and other shareholders acting together, holds more than 50% of the shares.

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.

In recent years, Inland Revenue has asserted tax avoidance in a number of transactions where the retained earnings of a company are extracted through share sales and where the economic effect of the transaction does not include a substantial change in ownership. This is commonly referred to as "dividend stripping" and the tax avoidance asserted by Inland Revenue is that the transactions were undertaken in lieu of the shareholders receiving a taxable dividend.

The discussion document notes that the proposal outlined above will provide greater certainty to taxpayers, so that they are clear on when a dividend may arise in relation to a share sale rather than having to consider if they are within the "dividend stripping" tax avoidance provisions.

2. Widening of the "personal services" attribution rules

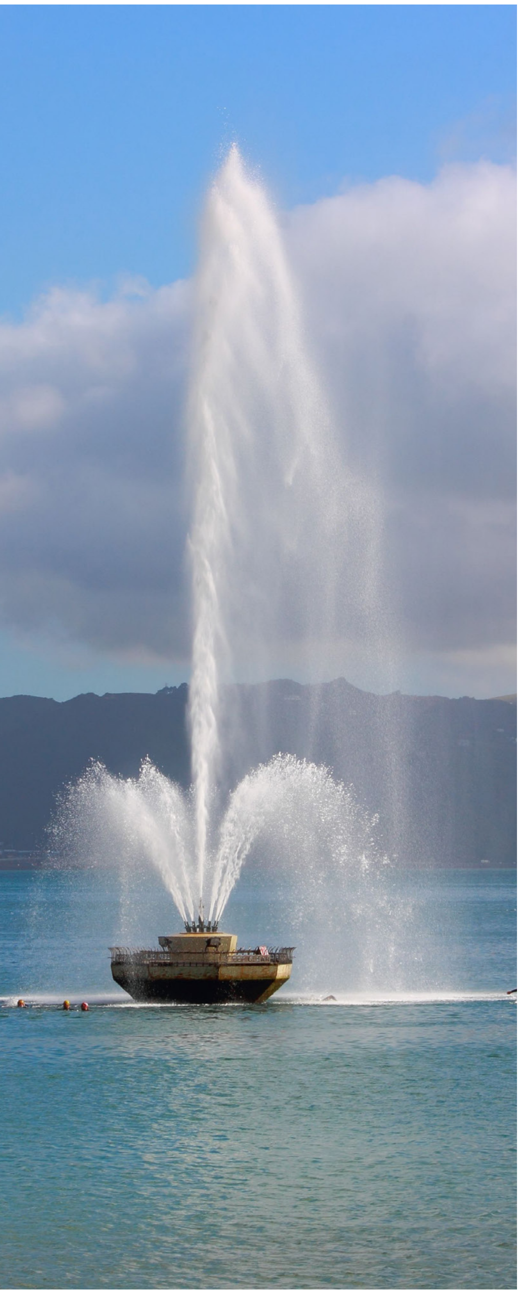
The Government proposes three changes to the personal services attributions rules:

1. **Removal of the "80 percent one buyer" rule**
   The personal services attribution rules will only apply if 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. The Government proposes to remove this requirement.
2. **Reduction of the "80 percent one natural personal supplier" rule**
   Another requirement for the personal services attribution rules to apply is that 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. The Government proposes to reduce the 80 percent threshold for the test to 50 percent.
3. **Increase in the substantial business assets test**
   Another requirement for the personal services attribution rules to apply is that "substantial business assets" are not a necessary part of the business structure that is used to derive the associated entity's personal services income. "Substantial business assets" means depreciable property that is not for private use and has a total cost of more than either $75,000 or 25% of the associated entity's total income from personal services for the year. The Government suggests two options for increasing the threshold:

   Option 1: The lower of $200,000 or 25% of the associated entity's total income from personal services for the year, excluding the cost of passenger or luxury vehicles unless the entity's business is a transportation business.

   Option 2: The lower of $150,000 or 25% of the associated entity's total income from personal services for the year, excluding the cost of passenger or luxury vehicles unless the entity's business is a transportation business.

Reasons that the Government gives for excluding vehicles from the substantial business assets calculation include noting that vehicles are not always purely business assets and that they are often more incidental rather than integral to the work performed by the working person.



3. **ASC and ACDA tracking accounts**

The third proposal is that companies be required to, on a prospective basis, maintain a record of their available subscribed capital (ASC) and available capital distribution amount (ACDA), so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation (or the application of the proposed deemed dividend rule).

Under current law, there is no explicit requirement for a company to maintain records in relation to its ASC or ACDA. 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, however there is no requirement to be reported to Inland Revenue annually.

Under option 1, it is proposed that failure to submit a return of the ASC and ACDA accounts by the relevant due date, would mean that a taxpayer could not increase either account balance for that period (except with the Commissioner's approval).

Under option 2, taxpayers would only be required to provide their ASC and ACDA accounts (and any supporting records) to Inland Revenue when this information is specifically requested (such as in the event of an audit). It is also proposed that, similar to option 1, failure to maintain tracking accounts could result in the company being unable to increase either account balance for that period.

The Government proposes that, regardless of whether option 1 or option 2 is enacted, any change to the rules would only take effect for transactions occurring after the new tracking account laws are enacted. For ASC and ACDA arising prior to the new law being enacted, a company will have the onus of proof in establishing the amount of ASC and ACDA at the time the accounts become relevant (for example during a share repurchase or a liquidation of the company).

Why is the Government proposing these changes?

As noted, the Government has stated that the purpose of these proposals is to ensure the 39% personal tax rate is effective in raising extra revenue. It views the ability of business owners to dispose of shares tax free as a potential area where that additional tax revenue is lost on earnings that would otherwise have been distributed as a taxable dividend.

The Government refers to the fact that the number of dividends paid by companies tripled immediately before the 39% personal tax rate came into effect as evidence that companies are being used to "store" earnings in order to avoid the higher personal tax rates applicable on dividends, with the ability to access those "stored" earnings via a non-taxable share sale as an area of concern.

Similarly, there is also a concern that owners of personal services businesses are able to "avoid" the higher personal tax rates by incorporating their business, hence the proposals to expand the scope of the current personal services attribution rules so that it has a much broader application.

Our view

We have an overarching concern that the current proposals, when combined with some of the recently enacted tax changes, significantly undermine the coherence of New Zealand's tax system, including concerns around horizontal equity – that is, two taxpayers earning the same amount of income could face very different tax outcomes.

While we recognise that this argument could be made for capital gains generally, it is the complexity which is of most concern – that is, different tax outcomes can apply depending on the source or nature of the income, and that this can apply to many taxpayers.

We provide comments on the specific proposals below.

1. Deemed dividend on share sale

On the face of it, we can understand the concerns raised by the discussion document in that, conceptually, there may be business profits which can be realised by a shareholder without additional tax to pay via a share sale. However, when the proposals are examined more closely, there is a real potential of overtaxation in a number of circumstances as well as the further divergence from the principle of horizontal equity. Furthermore, we are not convinced that the scenarios that would be captured can be categorised as tax avoidance in the form of "dividend stripping" as these proposals are intended to apply to sales to third parties also.

The key issue is that retained earnings do not necessarily reflect the true business profit which would be received by the shareholder. Examples include where the company has external funding or where there are capital losses. Equally, the amount of imputation credits that is held by a company may not reflect the true "undistributed" business profits either. 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.

Another fundamental issue is the lack of horizontal equity for different shareholders. Specifically, the proposal would only apply to "controlling shareholders" and will not apply to portfolio shareholders or to listed companies. 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 change the fact that a minority / portfolio shareholder would still benefit from the share sale if there is indeed an amount of the disposal price that represents undistributed business profits.

There is also a concern that the proposal draws a distinction between realised retained earnings and capitalised future earnings (i.e. goodwill), which we consider is unsupportable from an economic perspective. To illustrate, 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.

Finally, there is also a concern that the effect of the proposals would unduly be felt mostly by small and medium sized businesses 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 continue to grow (vs. having dividend paying policies which larger scale businesses may have).

We urge the Government and officials to reconsider these proposals in light of the concerns outlined above. We consider that the proposals risk creating unintended economic and behavioural consequences, including:

- creating an incentive to liquidate a business rather than sell it;
- creating a lock-in effect so that business owners avoid selling their business; and/or
- disincentivising businesses from expanding offshore.

2. Widening of the "personal services" attribution rules

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.

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.

Similarly, 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.

3. ASC and ACDA tracking accounts

The third proposal is that companies will be required to, on a prospective basis, 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.

We support this idea in principle. The Government is asking for submissions on whether these accounts ought to be maintained internally only, or submitted to Inland Revenue annually. Arguably, the second option reflects current practice, as the onus is on the taxpayer (to prove to the civil standard) to support an ASC or ACDA balance if challenged by Inland Revenue. On the one hand, we can see the attraction of requiring the information to be submitted to Inland Revenue annually as this will ensure the calculation is done to a good standard. However, on the other hand, this adds further compliance costs to companies.

On balance, we consider the requirement to provide the information to Inland Revenue to be preferred on the basis that this will ensure better information in the future provided that this requirement is on a prospective basis only.

What's next?

Submissions on these changes close on 29 April 2022. We expect that any changes would be introduced to Parliament in a tax bill later this year with an application date starting from the 2022/23 income year.

Finally, we note that these proposals are just the first of three tranches of changes. Next, Inland Revenue will consider "trust integrity and company income retention issues and integrity issues", and after that, the taxation of portfolio investment income. It will be interesting to see what proposals will be put forward in relation to the next two phases, in particular whether there is an appetite to increase the trustee rate from 33% to 39% to ensure there is integrity to the 39% personal income tax rate increase.

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