Tax Tips Alert | 3 December 2020

The new 39% tax rate: what happens now?

On Wednesday afternoon, the Government introduced a new tax bill to Parliament under urgency, which proposes a 39% tax rate on individual income over $180,000.

Given Labour's majority in Parliament, the bill has now been passed and will be effective for the start of the 2022 income tax year.

This new rate could form part of New Zealand's progressive tax system for years to come as the Government navigates an economic recovery, commitments to public services, and budgets to service the forecast growth in Government debt. The last top marginal rate change was on 1 October 2010, when the Government reduced the rate from 38% on income over $70,000 to 33%, where it has remained since.

The 2010 change harmonised the top personal rate with the trustee rate. As those rates once again diverge, we expect to see more housekeeping and restructuring activity in advance of 1 April 2021. However, tax avoidance jurisprudence has developed significantly since the last major divergence of the top marginal rate and trustee rate in 1999. Taxpayers should be wary of the key constraints we outline below.

New marginal tax rate

The new 39% marginal rate will apply to all employment income over $180,000 including extra pay earned in the course of employment, such as bonuses, back pay, redundancy, and retirement payments.

With the new income tax rate, many other changes need to be made to tax legislation. This will ensure the new rate does not create distortions across the taxation of other types of personal income. The other rate changes are to the:

- Fringe benefit tax: The rate on amounts of all inclusive pay over $129,681 will be 63.93% to ensure consistent treatment of cash and non-cash remuneration. This threshold differs from the income tax threshold because it is calculated on the after-tax value of non-monetary benefit i.e. taking into account PAYE which would otherwise have been paid.
- Employer's superannuation contribution tax retirement savings contribution tax: ESCT and RSCT will rise to 39% on superannuation contributions made for an employee whose ESCT rate threshold exceeds $216,000.
- Residential land withholding tax: RLWT will increase to 39% (except where the vendor is a company).
- Resident withholding tax: All the new rates will apply from 1 April 2021 with the exception of the higher RWT rate on interest, which will take effect from 1 October 2021 so that payers can make changes to their systems. The non-declaration rate of 39% will remain the same.

There will also be a new tax code for secondary income earners whose total PAYE exceeds $180,000. Other personal income tax thresholds and rates remain unchanged.

Trustee annual return changes

The bill also introduces significant new disclosure requirements for trustees to be provided as part of the 245,000 trustee tax returns Inland Revenue collects annually. The new disclosures will be used to assess compliance with the 39% rate and monitor the use of structures and entities by trustees.

The information required will include:

- profit and loss statements,
- balance sheet items, and
- "other information specified by the Commissioner".

The change will require the disclosure of the name, IRD number, and date of birth of beneficiaries and settlors as well as the information on those with the power to appoint or dismiss a trustee or to add or remove a beneficiary.

Importantly, the new rules will require the disclosure of names and details of settlors from prior years. However, these disclosure provisions will not apply to non-active trusts that are not required to file tax returns, trustees of foreign trusts, or charitable trusts that are incorporated under the Charitable Trusts Act 1957 (many of which report to Charities Services.). Existing penalty provisions which apply to false or omitted information in trustee returns will continue to apply.

As with the tax rate change, the disclosure rules will apply for the 2022 income year (for standard balance date taxpayers, this is the year ending 31 March 2022).

The new trust tax disclosure rules coupled with the new trust regime that applies from January 2021 means that the compliance costs of using a trust are increasing significantly and the purpose and benefit of new or existing discretionary trusts should be carefully evaluated.

Family tax credit

Other changes include an increase to the minimum family tax credit to $566 per week for families who work full-time and do not otherwise receive a benefit (to ensure they are on a higher income than if they received a benefit).

Responding to the change

The 39% tax rate complicates the tax system and widens the gaps between different rates. The same $1 of investment or business income can now be taxed at different rates depending on the entity in which it is derived. For example, if derived in a Portfolio Investment Entity (PIE), that dollar could be taxed at a maximum of 28%, in a company at 28%, in a trust at 33% or directly by an individual potentially at 39%. In contrast, $1 of personal services income over the $180,000 threshold will always be taxed at 39%. This reduces the horizontal equity of the tax system and may cause inefficient restructuring decisions. It's questionable tax policy design.

Housekeeping

It will be important to review your business and investment structure ahead of the change to consider whether there are any actions that should be taken in advance of the rate increase. These housekeeping actions could include distributing retained earnings and associated imputation credits from companies prior to the rate change, accelerating the payment of accrued bonuses or other salary entitlements, and considering the right level of shareholder salaries. You should make sure that current and future investments are held in the most appropriate entity for your circumstances (e.g. PIEs or investment companies or trusts).

Restructuring

The regulatory assessment that accompanied the bill acknowledges that some restructuring activity may occur in order to access lower tax rates than the 39%.

While restructuring may be technically feasible under our tax, company, and trust laws, the Government has issued a clear warning that it will carefully monitor that activity and may respond.

Individuals considering restructuring their affairs will need to carefully consider the existing constraints to rearranging their affairs to be comfortable that personal income can be derived by a different entity and access the lower tax rates. We have set out the existing constraints briefly below.

Penny & Hooper v Commissioner

The main tax avoidance case on personal services income is *Penny & Hooper v Commissioner of Inland Revenue [2011] NZSC 95*. Penny and Hooper were orthopaedic surgeons who initially practised as sole traders but established family trusts and companies, to which they transferred their employment contracts,and paid themselves an artificially low salary. There were no substantial changes in the business operation. The advantage produced by fixing the salary at a low level was seen as the predominant purpose of the arrangement and outside Parliament's "contemplation", which has been the prevailing standard for the last decade. The Supreme Court confirmed Inland Revenue's position that the restructure was tax avoidance and their original income should be taxed in their hands.

Principles of s BG 1 and Interpretation Statement 13/01

IS 13/01 is the 135-page interpretation statement published by Inland Revenue after *Penny & Hooper* and other landmark avoidance cases. It sets out the Commissioner's interpretation to section BG 1 (the general anti-avoidance provision) and section GA 1 (the reconstruction provision) in the Income Tax Act 2007. The three key steps are (1) glean Parliament's purpose from text, context, case law, and extrinsic material (2) ask whether the arrangement, viewed in a commercially and economically realistic way, uses the relevant provisions in a manner that is consistent with Parliament's purpose and (3) ask whether the tax avoidance purpose or effect flows naturally or is it an end.

Revenue Alert 11/02

Revenue Alert 11/02 considers when diverting personal services income by structuring revenue earning activities through an associated entity is tax avoidance. Inland Revenue says that its attention will be triggered by new entities whose operations nevertheless are unchanged and whether significant tax benefits are obtained.

Draft interpretation statement on personal services attribution

In anticipation of the new 39% tax rate, Inland Revenue is consulting on new guidance: PUB00321. The draft provides guidance on how to calculate the amount of income from personal services that is attributed to the working person under the attribution rule in the Income Tax Act 2007. The rule may apply if an entity earns income from supplying services that are personally performed by an associated person and is aimed at ensuring the appropriate amount of income is recognised as being the working person's income.

Please contact your usual PwC adviser if you would like to discuss anything in this Alert.

Contributors

Geof Nightingale
Partner
+64 21 940 346
geof.d.nightingale@pwc.com

Peter Boyce
Partner
+64 21 823 342
peter.boyce@pwc.com

Briar Williams
Partner
+64 21 260 6381
briar.s.williams@pwc.com

Michael Hansby
Associate
+64 21 154 3917
michael.w.hansby@pwc.com

pwc