



POLICY AND REGULATORY STEWARDSHIP

TE TAI ŌHANGA
THE TREASURY

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

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

Action sought

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

Contact for telephone discussion (if required)

Name	Position	Telephone
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Paul Young	Principal Policy Advisor, Inland Revenue	

2 February 2022

Minister of Finance
Minister of Revenue

Discussion document – Dividend integrity and personal services income attribution

Executive summary

Purpose

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

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

Proposals in the discussion document

The draft discussion document proposes:

- That any sale of shares in a company by the controlling shareholder be treated as giving rise to a dividend to the shareholder to the extent that the company (and its subsidiaries) has retained earnings. This will trigger a residual tax liability for the shareholder. The company should also have an increase in its ASC. This ASC increase will address a current inequity in the imputation credit continuity rules and prevent double taxation upon liquidation.
- That companies be required, on a prospective basis, to maintain a record of their ASC and net capital gains, so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation. These accounts would be similar to the imputation credit accounts already required to be kept.
- That the “80 percent one buyer” test for the personal services attribution rule (that is, at least 80 percent of the associated entity’s income from personal services during the income year is derived from the supply of services to one buyer in particular and/or an associate of the buyer) be removed.

Regulatory Impact Assessment

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

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

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

Next steps

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

Recommended action

We recommend that you:

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

Authorised

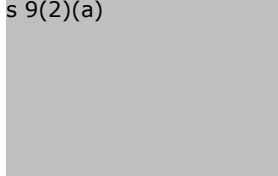
s 9(2)(a)



Stephen Bond
Manager
Tax Strategy
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Authorised

s 9(2)(a)



Paul Young
Principal Policy Advisor
Policy and Regulatory Stewardship
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2022

Hon David Parker
Minister of Revenue
/ /2022

Purpose

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

Context and background

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

Dividend integrity

4. The document firstly considers two issues with the current law and practice regarding income of companies received by shareholders. Distributions from companies are intended to be taxable income to the shareholders (dividends), unless excluded because they are either returns of contributed capital or a distribution on liquidation of net capital gains. Under the imputation system, taxable distributions from New Zealand companies can carry with them a credit for New Zealand income tax paid by the company. However, because the corporate tax rate is lower than the top personal tax rate and the trustee rate, there is often a residual tax liability for the shareholder (or the paying company, where Resident Withholding Tax is imposed).
5. Current law and practice offer a number of routes for shareholders to directly or indirectly realise cash (or other property) relating to earnings of a company without triggering any tax liability. The first issue considered in the document is sales of shares. A sale of shares offers an alternative way for a shareholder to realise cash, often but not always representing the earnings or capital gains of the company, with no, or a substantially deferred, tax cost.
6. When a company is sold, the purchaser's payment to the vendor includes the value of assets funded by retained earnings. Under current law, this payment is generally on capital account (non-taxable). Because a change of ownership will eliminate imputation credits, any subsequent distribution of the retained earnings will be taxable to the purchaser. However, if the purchaser adopts the simple expedient of acquiring 100 percent of the target using a holding company, this taxation is permanently eliminated by the inter-corporate dividend exemption.
7. Secondly, practical issues arise when a company cancels shares or is liquidated. At this point, the company's available subscribed capital (ASC)² and (in the case of a liquidation) net capital gains need to be determined, in order to determine the amount of the dividend on liquidation. However, there is currently no requirement for a company to have kept any record of these amounts during its life. This can make accurately determining the amount of a dividend on a share cancellation or liquidation highly problematic.

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

Personal services income attribution

8. The document also considers the scope of the personal services attribution rule and whether it may need to be expanded in light of recent developments such as the introduction of the new top personal tax rate of 39%.
9. The personal services attribution rule prevents an individual avoiding the top personal tax rate by diverting income to an associated entity. A typical scenario is where an individual incorporates a company to contract for services. The company contracts with the customer and pays the 28% corporate tax rate on its fee income. The company then employs or sub-contracts with the individual to provide the service, often at a below-market rate. The company can either retain its profit or pass the profit back to the taxpayer in a tax-advantaged manner (for example, through a trust).
10. The attribution rule for income from personal services applies when an individual (the working person), who performs personal services, is associated with an entity (the associated entity) that provides those personal services to a third person (the buyer). The rule only applies when various threshold tests are met, most notably:
 - 10.1 At least 80 percent of the associated entity's income from personal services during the income year is derived from the supply of services to the buyer or an associate of the buyer (or some combination thereof). This is referred to in the document as the "80 percent one buyer" rule.
 - 10.2 At least 80 percent of the associated entity's income from personal services during the income year is derived from services that are performed by the working person or a relative of theirs (or some combination thereof). This is referred to as the "80% one natural person supplier" rule.
 - 10.3 "Substantial business assets"³ are not a necessary part of the business structure that is used to derive the associated entity's income from personal services.
11. The combination of these tests targets the rule at individuals who, using an interposed entity, sell their labour to a buyer in the specific situation where these individuals would likely have traditionally supplied their labour as employees, rather than as independent contractors.
12. There is a risk that other taxpayers on the 39% personal tax rate who are not currently subject to the personal services attribution rule will use trusts and companies to obtain a lower tax rate on what is in fact personal services income. This is an issue both for taxpayers providing personal services to a single customer and taxpayers providing personal services to multiple customers. In each case, the economic reality is that the taxpayer is performing work and being paid for it – the entity is in effect a conduit for the taxpayer's income-earning activity. Consequently, the taxpayer should be taxed on their services income at the applicable marginal rate. However, the legal structure used allows tax to be paid at a lower rate.

³ "Substantial business assets" means depreciable property that has a total cost of more than either \$75,000 or 25 percent of the associated entity's total income from services for the income year. In the specific case of depreciable property subject to a finance lease or hire purchase agreement, the cost of the property includes the consideration provided to the lessee, including expenditure or loss incurred by the lessee in installing the asset for use (unless the lessee is allowed a deduction for the expenditure or loss).

Proposals in the discussion document

13. The draft discussion document proposes measures to address the issues described above and improve the integrity of the 39% personal tax rate and the dividend definition. In particular, it proposes:
 - 13.1 **That any sale of shares in a company by the controlling shareholder be treated as giving rise to a dividend to the shareholder to the extent that the company (and its subsidiaries) has retained earnings.** This would trigger a residual tax liability for the shareholder. The company should also have an increase in its ASC. This ASC increase would address a current inequity in the imputation credit continuity rules and prevent double taxation upon liquidation.
 - 13.2 **That companies be required, on a prospective basis, to maintain a record of their ASC and net capital gains,** so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation. These accounts would be similar to the imputation credit accounts already required to be kept, but would have fewer entries.
 - 13.3 **That the “80 percent one buyer” test for the personal services attribution rule be removed.** As outlined above, the 80 percent one buyer test narrowly targets the personal services attribution rule at taxpayers that are dependent on a single customer (and so are closer to employees). However, as stated above, the problem is not limited to just those taxpayers that are dependent on a single customer. Therefore, there may be a good argument for removing the 80 percent one buyer rule altogether.
14. Each of these proposals is independent of the others, though the second would be a useful support for the first, as well as for current law.
15. The discussion document also canvasses the following issues in relation to the personal services attribution rule:
 - 15.1 In some circumstances, the “80 percent one natural person supplier” test might be seen as too restrictive. Conceivably, there may be another individual (unrelated to the working person from whose efforts most of the associated entity’s income from personal services is derived) whose labour contributes more than 20 percent of the associated entity’s income from personal services. There is a question as to whether it is correct from a policy perspective that attribution does not apply even if the associated entity’s income from personal services is *mostly* derived by the efforts of one person and/or a relative of theirs, simply because the entity’s income from services is not almost entirely derived by the person’s and/or a relative’s efforts. This is essentially a question about where the threshold for attribution should be for the level of contribution from the working person, rather than a significant change in intended scope.
 - 15.2 The threshold for the substantial business assets test has not changed since the introduction of the personal services attribution rule in 2000. There is a question as to whether the \$75,000 threshold in this test should be revised upward so that it is set at a level that more accurately reflects the cost of business assets today. Officials note that any increase in the threshold will not affect taxpayers whose business assets cost more than 25% of their income. The effective threshold will therefore only be greater than \$75,000 where the income from personal services for the income year is greater than \$300,000.

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

Financial implications

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

Regulatory Impact Assessment

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

Next steps

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