Inland Revenue
Te Tari Taake

TE TAI ŌHANGA
THE TREASURY

Briefing note

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To: Tax Advisor, Minister of Finance – Claire Mclellan
Revenue Advisor, Minister of Revenue – Matthew Atherton
Private Secretary, Minister of Revenue – Nikki Chamberlain
Revenue Advisor, Parliamentary Under-Secretary to the Minister of Revenue – Ruairi Cahill-Fleury

From: Paul Young

Subject: **Dividend integrity – Consultation feedback on share sales proposal**

Purpose

1. We have been consulting with stakeholders on the proposals in the discussion document *Dividend integrity and personal services income attribution* (the discussion document). While submissions are not due until 29 April, this report alerts you to the feedback on the share sales proposal.

Context and background

2. The discussion document, released last month, is the first tranche of the Government's work on measures to support the integrity of the top personal income tax rate of 39%. Among other things, the 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 undistributed earnings other than from capital gains. This would trigger a residual tax liability for the shareholder. The discussion document included three options as to how broadly the proposal would apply:

   (A) where the shareholder retains economic ownership (related-party transactions);

   (B) where the shareholder sells to an unrelated company; and

   (C) where the shareholder sells to an unrelated individual.

3. Rather than being a primarily anti-avoidance measure, the share sales proposal would address a more fundamental matter about ensuring that company tax is not a final tax on income. The proposal would do this using share sales. The proposal would mean that whenever shares are sold in a controlled company, the component of the sale price that relates to the retained earnings is taxed as a dividend in the hands of the exiting controlling shareholder. Accordingly, genuine commercial sales to third party buyers *would* be taxed (to the extent of the company's retained earnings) if the sale is by a controlling shareholder (that is, someone holding more than 50 percent of the company's shares).

4. As a result, the options in the proposal are wide-reaching and would over time affect a large number of small and medium businesses, as well as some very large privately held businesses. These wide-reaching impacts raise the biggest concerns for stakeholders, in particular the application of the proposal to third party sales (options B and C).

5. As you may recall, the discussion document also contained proposals around available subscribed capital and the personal services income attribution rule. Stakeholder reaction to the available subscribed capital and net capital gains tracking accounts proposal has generally been positive. While there have been some concerns raised with the income attribution proposals, we are confident that we can resolve the issues in the time available to include finalised proposals in relation to these issues in the August tax bill.

Consultation

6. We have been meeting with stakeholders to work through the discussion document proposals and want to alert you to the feedback received so far in relation to the share sales proposal. These discussions have made it evident that stakeholders do not agree with the fundamental premise of the proposal as it relates to unrelated party sales, and have also revealed considerable complexity and risk of overreach in the proposal, beyond the level of concern that officials had anticipated. Concerns raised by stakeholders include:

- **The breadth of the proposal:** Stakeholders say that recharacterising some of the proceeds from share sales as dividends where there is no intention of tax avoidance would be an overreach, and that the focus of the proposals should be on the most egregious cases, being sales between related parties (option A). In particular, they are concerned that the proposals would potentially affect a large number of small and medium businesses who under current law are clearly not subject to tax when they sell their shares.
- **The effect the proposal would have on business growth and succession planning:** For example, a small business owner may want to introduce a new owner to the business to benefit from their skills or experience. Alternatively, a small business owner such as a builder or plumber may want to retain a key staff member (such as an apprentice that they have trained) with a view to having the staff member eventually succeed them and keep the business going after the current business owner has retired. A way that the business owner can do this is by selling some of their shares to the other person. Stakeholders are concerned that the proposals would penalise, or act as a barrier to, this form of business expansion or succession planning.
- **Their view that the proposal is a capital gains tax:** Because the proceeds from a sale of shares are generally capital proceeds, in stakeholders' view, recharacterising some or all of the sale proceeds as a taxable dividend is a capital gains tax.

7. Stakeholders have also raised a number of practical issues with some details of the proposal, for example:

- How the deemed dividend is quantified (two approaches are in the document, using imputation credits and retained earnings, and how these would interact has raised a number of technical issues).
- The extent to which application of the rule only to sales by controlling shareholders could be broadened by also including sales where shareholders "act together" – questions include how broad this would be and how it would be defined.

8. In general, stakeholders have expressed concerns with the amount of material they are required to submit on, and in relation to the 39% integrity consultation, they

are concerned about the length of time (six weeks) to provide feedback on such a fundamental change to the tax system. They are also concerned about the short timeframe between submissions closing and introduction of the proposals in an omnibus taxation bill later this year (currently planned for August).

9. Given the complexity and the various issues that need to be worked through, stakeholders are concerned that the resulting legislation (which officials have indicated is intended to be effective for sales occurring on or after 1 April 2023) will not be workable for taxpayers and that the amount of time between legislative enactment and the application date might only be a few days.

Officials' views and next steps

10. While we do not agree with all the points raised by stakeholders, they do raise a number of valid points that we would like to consider further. We will continue to work through the proposals with stakeholders and will report to you in May on the submissions and our recommendations.

11. Following that report, the key milestones for including the proposals in the August bill are:

- 22 June – Consideration by DEV
- 27 June – Cabinet approval of final policy
- July/August – Cabinet approval for including proposals in omnibus tax bill.

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