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POLICY AND REGULATORY STEWARDSHIP

Tax policy report: **Dividend integrity and personal services income attribution – Summary of submissions and next steps**

Date:	26 May 2022	**Priority:**	Medium
Security level:	In Confidence	**Report number:**	IR2022/283 T2022/1166

Action sought

	Action sought	**Deadline**
Minister of Finance	**Agree** to the recommendations in this report **Discuss** at your meeting with officials on Thursday 2 June	Thursday 2 June 2022
Minister of Revenue	**Agree** to the recommendations in this report **Discuss** at your meeting with officials on Thursday 2 June	Thursday 2 June 2022

Contact for telephone discussion (if required)

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26 May 2022

Minister of Finance
Minister of Revenue

Dividend integrity and personal services income attribution – Summary of submissions and next steps

Executive summary

Purpose

The submission period for the Government discussion document *Dividend integrity and personal services income attribution* ("the Discussion Document") closed on 29 April 2022. Cabinet had previously invited you to report back in June 2022 on the outcome of the consultation and to provide final policy proposals (DEV-22-MIN-0028 refers). This report provides you with a summary of the feedback provided by submitters and our advice on the next steps.

Proposal 1 – Share sales

The Discussion Document proposed that any sale of shares in a company by the controlling shareholder be treated as giving rise to a dividend in the hands of that shareholder to the extent that the company and its subsidiaries have retained earnings. Submitters strongly opposed this proposal. Submitters' key concern was that the proposal is a fundamental change to the tax system and many considered it to be a form of capital gains tax. Submitters argued that any change should be limited to share sales between related parties and the most egregious behaviour. Other key concerns relating to the details of the proposal were that the rules would:

- discourage business investment and innovation,
- create problems for succession planning, mergers and acquisitions and employee share schemes; and
- mostly impact small and medium businesses as well as family-owned companies, adding significant compliance costs for this group and resulting in arbitrary and unfair outcomes.

While we do not agree with all the submissions, we do agree the proposal as set out in the Discussion Document would be a significant change and that submitters have raised valid concerns about the details of the proposal that cannot be resolved quickly.

Both agencies recommend, as a first step, developing a targeted rule applying to related party transactions to deal with the transactions that are the most likely to be specifically tax motivated. This targeted rule could also cover transactions that shelter the company's future earnings. The details of this work could be consulted on and legislation introduced in the first quarter of 2023, to apply from a date such as the date of enactment or a fixed date soon after.

However, Inland Revenue and the Treasury have different views on how changes for third-party sales should proceed.

Inland Revenue officials recommend that a wider rule to cover third-party transactions be considered over a longer timeframe. Specifically, we could consider what priority to give a

wider rule when we report on the measures under tranche two. This would allow Ministers to better assess wider integrity issues across the tax system and what the highest value measures are given the finite policy resources available. The tranche two advice is dependent on information from the additional trust disclosures, due to be received in full at the end of March 2023. The resulting advice will therefore be provided later in 2023.

Treasury officials recommend agreeing in principle to a third-party rule to be developed following the introduction of a related party rule. While the Treasury accepts stakeholder feedback that it is a more fundamental change and therefore further work on implementation and a longer transition period would be sensible, it does not believe that further policy work or consultation would materially change the outcome of any policy analysis. In Treasury's view, the positive impacts on social capital, the fiscal position, and horizontal and vertical equity outweigh what are likely to be relatively low economic costs. Announcing that a third-party rule is being progressed would also provide greater certainty to stakeholders. Under this approach a third-party rule would be progressed in a subsequent omnibus tax bill.

Proposal 2 – ASC and capital gains reporting

The second proposal was that companies be required, on a prospective basis, to maintain a record of their available subscribed capital (ASC)[1] and net capital gains, so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation. Submissions were invited on whether there should be a requirement to report these accounts to Inland Revenue annually, or if taxpayers should instead merely be required to maintain and keep these records. Submissions on this proposal were more supportive, although some considered legislative changes in this area to be unnecessary. Submissions included:

- That these records will be useful when a transaction requiring this information occurs.
- There will be compliance costs associated with collating and maintaining the accounts and associated records, particularly for small businesses. To address this issue, some submitters suggested a de minimis below which taxpayers are not required to maintain records (and report them).
- Requiring annual reporting of these records to Inland Revenue will increase compliance costs. If reporting is required, the time bar should apply.

We note the submissions in support of the proposal but also recognise the additional compliance cost. While we recommend progressing this proposal, we consider that the best way to reduce compliance costs is to work with accounting platform software providers to develop the reporting requirements. We recommend that we do this over the second half of this year with a plan to introduce the relevant legislative amendments early in 2023 to apply from 1 April 2024.

Proposal 3 – Personal services attribution rule

The third proposal was to remove the "80 percent one buyer" test[2] for the personal services attribution rule where income from personal services is taxed at the person's marginal tax rate (as opposed to the company and trustee tax rates). In addition, the Discussion

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

[2] 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 and/or an associate of the buyer.

Document suggested changes to the other threshold tests for the rule, such as increasing the substantial business assets threshold.[3] Submissions on the proposed changes included:

- That the current rule is deliberately targeted to quasi-employment situations and the proposals significantly and inappropriately widen its scope. Specifically, the changes would go beyond people trying to avoid the 39% tax rate by using a corporate or trust structure and instead capture legitimate businesses.
- That the changes would introduce a competitive disadvantage for small personal services businesses compared to other businesses who are not subject to the proposals (such as larger personal services businesses and businesses that are providers of goods rather than personal services).
- The proposals would increase compliance costs, as well as reduce these businesses' ability to reinvest retained earnings. This will have a negative impact on their ability to grow.
- That there is no evidence justifying the changes proposed, and the effect of these changes will go well beyond the stated problem that they are trying to address.

Depending on their design, the changes could significantly widen the scope of the personal services attribution rule to include service providers with multiple clients, such as real estate agents, plumbers, IT contractors and hairdressers. If widely drafted, these rules could capture up to 8,000 one-person service companies.

By their nature, the personal services attribution rules are somewhat arbitrary and can create competitive distortions. Given the proposals would widen the scope of these rules, these competitive distortions could be exacerbated. While we recommend proceeding with these changes, we would like additional time to work through the detailed design options to address some of the negative impacts.

We propose to further develop the design of the rules and then consult on the detail to allow stakeholders to identify any issues with the updated proposals. Legislation could then be introduced in early 2023, with the changes applying from 1 April 2024.

Next steps

We are scheduled to discuss the recommendations in this report at the joint Ministers' meeting on 2 June.

You previously agreed to progress these integrity proposals in the next omnibus tax bill scheduled for introduction in August 2022. Given the delays in releasing the discussion document and the short time between now and the introduction of the bill, further time to consider the feedback from submissions and refine the proposals would be beneficial. We recommend progressing any changes in a tax bill to be introduced in early 2023. This would also allow further time to consult on more detailed proposals to address practical issues.

If you agree to this timeframe, we will report to you in August or September with a draft issues paper on more detailed and refined proposals for further consultation.

If you wish to proceed with any of the proposals on a faster track, we can discuss how that might be achieved in the time available. Officials note there are substantial risks in

[3] The personal services attribution rule does not apply if the business has "substantial business assets" used to derive the income from personal services. "Substantial business assets" means depreciable property that has a total cost of more than either $75,000 or 25 percent of the company's total (gross) income from services for the income year.

proceeding on a faster track, although it could enable implementation to occur a year earlier.

We seek permission to update stakeholders once decisions have been made on the progression of this work.

Recommended action

We recommend that you:

Share sales proposal

1. **agree** that officials should develop a targeted share sale rule for related party share sales;

   Agreed/Not agreed   Agreed/Not agreed

2. **agree** to further consult on the detail of a rule for related party share sales by way of an officials' issues paper released in the second half of this year;

   Agreed/Not agreed   Agreed/Not agreed

3. **agree** to include a rule for related party share sales in an omnibus bill to be introduced in early 2023;

   Agreed/Not agreed   Agreed/Not agreed

4. EITHER:

   4.1 **agree** not to proceed with a rule for third-party share sales at this time and **direct** officials to consider whether a rule for third-party share sales should be progressed as part of tranche two of the 39% rate integrity work *(Inland Revenue's preferred approach)*;

   Agreed and directed/Not agreed   Agreed and directed/Not agreed

   OR

   4.2 **agree** to proceed with a third-party share sales rule, after the introduction of the related party rule, in a subsequent omnibus tax bill *(Treasury's preferred approach)*;

   Agreed/Not agreed   Agreed/Not agreed

ASC reporting requirements

5. **agree** that officials should develop ASC and net capital gains reporting requirements with accounting platform software providers for inclusion in a bill to be introduced in early 2023 with application from 1 April 2024;

   Agreed/Not agreed   Agreed/Not agreed

Personal services attribution rule

6. **agree** to proceed with removing the 80 percent one buyer test in the personal services attribution rule and for officials to report back on proposals to address stakeholder concerns about compliance costs and competitive distortions;

   Agreed/Not agreed   Agreed/Not agreed

7. **agree** to include changes to the personal services attribution rule in the tax bill to be introduced in early 2023 with the changes applying from 1 April 2024;

   Agreed/Not agreed Agreed/Not agreed

8. **agree** that officials report back around August with more detailed proposals with an attached issues paper for further consultation;

   Agreed/Not agreed Agreed/Not agreed

Process

9. **discuss** this report with officials at the Joint Ministers' meeting on 2 June 2022;

10. **agree** to allow officials to inform stakeholders of the decisions made in this report;

    Agreed/Not agreed Agreed/Not agreed

11. **note** that officials from both agencies are working on long-term strategic options for managing misalignment;

Financial implications

12. **note** that there are some indicative costings in the report and that officials will provide further details of the financial implications of the proposals when reporting back on the detailed design of the policies later this year.

s 9(2)(a)

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Purpose

1. This report provides you with a summary of the feedback provided by submitters on the Government discussion document *Dividend integrity and personal services income attribution*, as well as our advice on the next steps and timeframe for progressing these measures.

Context and background

2. The Government introduced the 39% tax rate for income above $180,000 from 1 April 2021. When this rate was introduced, Ministers indicated that integrity measures would be considered if behaviours aimed at avoiding the application of the 39% rate were observed.

3. Cabinet recently approved the release of the Government discussion document *Dividend integrity and personal services income attribution* for public consultation ("the Discussion Document"). The Discussion Document stated that the Government's objective is to ensure the continuity of revenue streams by ensuring that the tax system is fair and progressive, and that everyone pays their fair share of tax. It noted that the bunching of self-employed people at the relevant tax thresholds indicates that there is an existing issue, especially for relatively high-income taxpayers. The period for submissions closed on 29 April 2022. The Discussion Document outlined three main proposals:

   3.1 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 undistributed earnings other than capital gains. **(Proposal 1)**

   3.2 That companies be required, on a prospective basis, to maintain a record of their available subscribed capital (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. **(Proposal 2)**

   3.3 That the "80 percent one buyer" test for the personal services attribution rule be removed and the significant asset threshold be increased. **(Proposal 3)**

4. These integrity measures – and those in future tranches – aim to buttress higher personal income tax rates on labour income than other rates in the tax system. They are not a complete solution to the challenges of misalignment. Specific rules are inherently complicated and carry unintended consequences. Therefore, the decision to proceed with such measures is a trade-off between complexity and unintended consequences and the positive benefits that buttressing higher personal tax rates has for social capital, revenue, and the fairness of the tax system.

5. Officials from both agencies are working on strategic options for managing misalignment in the future, but that work would be fundamental and would necessarily take longer and require more careful consultation. Therefore, specific integrity measures remain appropriate as a near term solution.

6. In total, 40 submissions were received on the Discussion Document from private sector tax advisors, tax and business advocacy groups, and from small businesses and private individuals. Submissions on the share sales and personal services attribution proposals were strongly opposed to the measures, while submissions on the proposal about tracking ASC and net capital gains were mixed but generally more supportive.

7. Rather than being viewed as integrity measures, both the share sales and personal services attribution proposals were considered by submitters to be fundamental

changes to the income tax system involving substantial overreach. Many viewed the proposals as a departure from New Zealand tax principles, which allow the use of companies for income tax purposes, by requiring the integration of corporate and personal income. Submitters considered the proposals would discourage small business owners from retaining earnings in their companies to invest in new assets which they said would have implications for productivity and economic growth. Rather than making such fundamental tax changes, several submitters considered the issues would be better addressed by increasing enforcement of the existing tax rules. However, some thought there might be some justification for a share sales rule for transactions between related parties but only if the existing tax rules are not sufficient.

Share sales (proposal 1)

8. Under current law, the sale of shares is usually treated as being on capital account and is not taxed. This is not the case where the sale is considered to involve tax avoidance such as where there is "dividend stripping." In broad terms, "dividend stripping" refers to a situation where a shareholder of a company avoids receiving a taxable dividend by selling their shares for a non-taxable capital amount, often without a change in the economic ownership of the acquired company.

9. The Discussion Document proposed that any sale of shares in a company by the controlling shareholder would be treated as giving rise to a dividend to the shareholder to the extent that the company and its subsidiaries have retained earnings (the "share sales proposal"). This is intended to ensure that there is consistent tax treatment across the range of transactions where the value of earnings retained in a company can be realised by a shareholder.

10. The Discussion Document outlined different scenarios where the share sales proposal could apply, from a narrow focus on related party sales (potential avoidance situations) to broad application to third-party sales (situations where avoidance is less of a concern).

Submitters' views

11. In general, submitters considered the proposals to be an overreach as they felt that the proposals should be targeting avoidance transactions and would instead have a wide impact. Submitters argued that in third-party sale situations, most transactions do not give rise to avoidance concerns and are carried out for genuine commercial reasons.

12. Several submitters argued that the share sales proposal is effectively a capital gains tax, as the proceeds from a sale of shares are generally capital proceeds under current law and, as such, are non-taxable. Some also stated that since no value is transferred from the company itself to the shareholder, the proceeds from the sale are not a distribution from the company in form nor in substance, and therefore recharacterisation of these amounts as dividends is conceptually incorrect.

Scope of proposal

13. Submitters were generally opposed to the breadth of the proposal, in that it would apply to all share sales by a controlling shareholder, and not just those sales with a purpose of tax avoidance. Several stated that if the proposal proceeds, it should be limited to transactions between related parties only, or to transactions that have the hallmarks of a tax avoidance arrangement. One submitter suggested narrowing the scope of the proposal to sales by natural persons who are on the top personal tax rate of 39% so that it would not apply to sales by holding companies, nor to sales by natural persons on a lower marginal rate. Two submitters suggested that

a de minimis based on the value of the transaction should apply, with one of those submitters suggesting a threshold of $1 million.

14. While some submitters suggested that the changes were targeting small businesses and family-owned companies, one submitter (whose clients are largely small businesses) thought that small business owners would almost never sell a business by selling the shares in the company. This is because, by buying the assets of the company rather than the company's shares, the purchaser can protect themselves from any liabilities that might have been incurred by the company prior to the acquisition. This means that the proposal would not typically capture sales of small businesses, as it does not apply to asset sales.

15. Two submitters considered the limitation of the proposal to sales by controlling stakeholders to be appropriate, but most considered it to be unfair, arbitrary and discriminatory to small and medium companies and family-owned companies. They noted that this meant the proposal would not apply to a 49 percent shareholder but it would apply to a 51 percent shareholder in the same company. Submitters considered it unfair that the proposal would not apply to a sale of shares in a large, publicly listed company (except in the unlikely scenario where a majority stake in the company is sold).

16. Some submitters were concerned that the proposal could affect employee share schemes and create barriers to succession planning and to company mergers and acquisitions. For example, an employee share scheme may be established with shares contributed by the controlling shareholder (which is common in the succession planning context). Under the proposal, a tax liability would arise for the selling shareholder, assuming the company has undistributed earnings.

Definition of "controlling shareholder"

17. There were also concerns about how a "controlling shareholder" might be defined. The Discussion Document proposed that the proceeds from a share sale would be recharacterised as a dividend if the selling shareholder, together with associates and other shareholders "acting together", controlled the company immediately before the sale. One submitter considered the definition of "controlling shareholder" should be narrowed to just those shareholders that individually have more than 50 percent of the voting interests in the company.

18. Others noted specific concerns with the "acting together" part of the proposed rule. In particular, they noted shareholder agreements with "drag along" or "tag along"[4] clauses are common and stated that minority shareholders party to these agreements should not be regarded as "acting together" solely by virtue of the existence of such clauses.

19. One submitter said there should be no associates test for the purposes of the proposed share sale rule, while another requested more guidance as to who could be associated for the purposes of the rule. Specifically, they requested clarity as to whether genuine sales between family members (where no holding companies are created or involved in the transaction) would be caught.

Calculation of deemed dividend amount

20. A number of technical points were raised in submissions about the method proposed for calculating the amount of the deemed dividend. Submitters were generally concerned that the proposed methodology would in some cases lead to over-taxation or even double taxation. Submitters were also concerned about the

[4] A "drag along" clause allows majority shareholders to force minority shareholders to participate in a sale, usually on the same terms as the majority shareholders. A "tag along" clause is a clause that allows minority shareholders to join in on a majority shareholders' sale (also usually on the same terms as the majority shareholders).

complexity involved in the calculations, which they considered would give rise to compliance costs and, in some cases, over-taxation when taxpayers did not have satisfactory evidence of retained earnings.

Officials' view

21. While we do not agree with all the submissions, we do agree that the proposal as set out in the Discussion Document would be a significant change and that submitters have raised a number of valid concerns that cannot be resolved quickly.

22. The question of how broadly these rules should apply depends on the objectives:

    22.1 Applying the proposed rules to related party transactions is consistent with the objective of addressing avoidance concerns associated with the misalignment of corporate and personal tax rates;

    22.2 Applying the proposed rule more broadly to include third-party transactions is consistent with the objective of enhancing integrity by expanding the tax base so that personal tax rates are applied to income earned by closely held companies that is not distributed but nevertheless realised by the shareholder when it sells its shares. As a result, a broader rule would target the Government's integrity objectives of ensuring the tax system is progressive and that everyone pays their fair share of tax.

23. Both agencies recommend that initially a narrower proposal targeting related party transactions be developed to deal with the area in which transactions are most likely to be specifically tax motivated and therefore raise the greatest avoidance concerns. This proposal could also be designed to cover transactions that shelter the future profits of the company, such as selling the shares in the company to a related holding company that has been structured to have available subscribed capital or debt. This would then allow them to pay future profits out through the holding company without any further taxation.

24. The Discussion Document suggested that these proposals could be progressed in the omnibus tax bill scheduled for introduction in August this year with application from April 2023. However, given the level of complexity and the issues raised by submitters, there is value in taking more time to consider this feedback and consult further on the detail of such a rule. More detailed consultation would cover:

    24.1 the scope of the rule (that is, the definition of a related party transaction);

    24.2 the impact of such a targeted rule (how many transactions the rule may apply to and the fiscal impact);

    24.3 options to address the concerns raised around the definition of "controlling shareholder" and the proposed acting together rule;

    24.4 the interaction with existing anti-avoidance rules concerning dividend stripping; and

    24.5 the method of calculating the deemed dividend.

25. If Ministers agree, we will prepare an officials' issues paper with more detailed proposals later this year to be progressed in legislation to be introduced in the first quarter of 2023. To mitigate the risk of taxpayers structuring around the rule before it applies, such a rule should apply to transactions from the date of enactment of the legislation or a fixed date soon after. This means such a rule would apply to transactions entered into on or after a date in 2023 agreed by Ministers rather than applying from the beginning of the next income year.

26. If Ministers wish to fast track the proposal, there is a greater risk of unintended consequences. This includes affecting people who are not intended to be caught by the reforms. Providing additional time would also allow us to gather data to better determine who would be affected by the changes, including the fiscal implications. Therefore, we do not recommend fast tracking the proposal.

27. While both agencies agree on the approach to related party sales, Inland Revenue and the Treasury have different views on how changes in respect of third-party sales should proceed.

28. Inland Revenue officials recommend that work on a wider rule to cover third-party transactions be considered over a longer timeframe. This would allow officials to consider which integrity issues have the highest priority and how to best allocate policy resources in light of these priorities, as well as plan the timing of the work on these issues. We could report to Ministers on these matters when we report on the proposed measures for tranche two. This would allow Ministers to better assess wider integrity issues across the tax system and what the highest value measures are given the finite policy resources available.

29. The Treasury recommends that Ministers should agree in principle to proceed with a third-party share sales rule after the introduction of the related party rule. The third-party rule could proceed in a subsequent omnibus tax bill.

30. The Treasury takes this view because a third-party rule would:

    30.1 address longstanding integrity issues with the current system, including those noted by the Tax Working Group, that pre-date the current 39% rate by better capturing the full range of transactions where the value of earnings retained in a company is realised by an exiting controlling shareholder by way of a share sale;

    30.2 support both horizontal and vertical equity, as well as favourable perceptions of the fairness of the tax system which contribute to overall social capital;

    30.3 raise revenue for the Crown in a way that is likely to be progressive and come at a lower economic cost. While a higher effective tax rate on investors in close companies, all else being equal, could discourage investment at the margin, it is also making the tax treatment of income earned in different ways more neutral.

31. The Treasury does not recommend delaying commencement of work on a third-party rule until tranche two. Consultation has already been carried out on the proposal, and submitters are unlikely to change their views. If Ministers still want to achieve the objectives of a third-party rule, then we consider that giving stakeholders more certainty that such a rule will be put in place would allow for more productive consultation on implementation. It would also allow further work to focus on the concerns already raised and lessons learned from the related party rule.

Recording ASC and capital gains (proposal 2)

32. When a distribution is made to shareholders on a company liquidation or share repurchase, determining the dividend amount requires subtracting the available subscribed capital (ASC) and capital gain amount. Because a company may have been in existence for a long time before liquidation and the amounts may not be relevant before then, it is sometimes difficult for the company to determine them by going through historical records and for Inland Revenue to verify them.

33. To improve the reliability of this information, the Discussion Document proposed that companies would be required to maintain a record of their ASC and net capital

gains. It proposed that this requirement would only apply to transactions that occur after the law is enacted. To the extent a company's ASC and net capital gain figures rely on transactions occurring before that date, the current law would continue to apply. This means an existing company would have the onus of proof (as is the usual case for tax matters) in establishing the amount of its pre-application date ASC and net capital gains, but this burden can be satisfied at the time these amounts become relevant (that is, when shares are repurchased, or liquidating distributions are made to shareholders).

34. The Discussion Document invited submissions on whether annual reporting of ASC and net capital gains should be required, or whether taxpayers should merely be required to maintain and keep records of these amounts. In either case, the Discussion Document proposed that taxpayers would have deemed ASC and net capital gains of zero if the accounts were not maintained on a timely basis.

Submitters' views

35. Submissions on the proposal were generally more supportive than on the share sales and income attribution proposals, although some considered the proposed changes to be unnecessary and did not think the compliance costs associated with the proposal were justified. One submitter agreed that companies should be maintaining tracking accounts for ASC and net capital gains, but they thought that existing operational guidance on the matter should be sufficient to alert companies to the onus of proof requirements.[5] As an alternative to the proposed approach, one submitter suggested that company directors could instead be required to retain a copy of each year's financial statements for the life of the company.

Maintaining tracking accounts

36. Two submitters stated there should be a de minimis below which taxpayers are not required to maintain and report tracking accounts for ASC and capital gains. Two others suggested that taxpayers should have the option of not holding contemporaneous records at their discretion, and that Inland Revenue should not request the records unless the taxpayer has undertaken a transaction that utilises a claimed amount of ASC or net capital gains.

37. One submitter noted that maintaining tracking accounts for ASC and capital gains can be burdensome in the context of an employee share scheme. In this context, they suggested allowing businesses to opt out of contemporaneously recording relatively small ASC amounts, and to instead allow these records to be reconstructed and included at a later date if the ASC is to be utilised.

Periodic reporting and application of statutory time bar

38. Submitters' views on whether annual reporting of ASC and net capital gains should be required were mixed. Six were broadly supportive of annual reporting, although most stated that the statutory four-year time bar should apply to the returns of these amounts, some going as far as saying they only supported annual reporting on the condition that the time bar would apply. Three others were also supportive of a reporting requirement, just not annual reporting. Two of these submitters recommended requiring reporting on a three-yearly basis, while one submitter stated that these amounts should only be required to be reported to Inland Revenue whenever a dividend is paid.

[5] Under the current rules, even though there is no formalised requirement for taxpayers to maintain tracking accounts for ASC and net capital gains, the onus is on taxpayers to substantiate a claimed amount of ASC or net capital gain when a transaction utilising either of these amounts occurs.

39. Four submitters were opposed to periodic reporting. They considered the case for mandatory reporting to be unclear, as there is an incentive for taxpayers to maintain accurate records due to the high cost of failing to do so. They considered that it should be generally sufficient for taxpayers to maintain and keep these records so that they can be provided when requested by Inland Revenue.

40. One submitter commented on the suggestion in the Discussion Document that taxpayers that have not maintained tracking accounts would be deemed to have zero ASC or net capital gains. They considered the proposed treatment to be overly harsh, stating that there are many valid reasons why the records might not be prepared on a timely basis and that taxpayers should be allowed to reconstruct the necessary records if and when they are required.

Transitional issues

41. Submitters who commented on the proposed transitional rule (that is, applying the existing law to pre-application date ASC and capital gains of existing companies) were mostly supportive of the proposed approach.

42. One submitter requested more lead-in time to allow Inland Revenue to prepare guidance and education sessions, as well as for businesses and their advisors to prepare. The submitter noted that digital service providers such as accounting software packages will be critical to the implementation of the proposed changes.

Officials' view

43. We note the submissions in support of the proposal but also recognise that there will be some additional compliance costs. We consider these compliance costs are justified on the basis that taxpayers should ideally be recording ASC and net capital gains anyway and maintaining adequate supporting documentation, given the onus is on taxpayers to substantiate a claimed amount of ASC or net capital gain under the existing rules.

44. While the existing onus of proof requirements mean that companies already have an incentive to maintain a record of their ASC and net capital gains, timely and accurate record keeping is still an issue in practice, particularly for smaller companies. For ASC in particular, this is at least in part because the figure will never be relevant in many cases. In instances where a company *does* have to determine its ASC or net capital gains, it requires a careful record of both the law and transactions going back to the formation of the company.

45. On balance, officials recommend proceeding with the proposal to require annual reporting of ASC and net capital gains. As some submitters noted, there is the risk that some taxpayers, particularly smaller ones, will not comply with the requirement to maintain and keep records of ASC and net capital gains unless there is an annual reporting requirement. We consider that the process for reporting these amounts could be kept relatively simple, similar to the existing process for reporting imputation credit accounts.

46. We consider the best way to reduce compliance costs will be to work with providers of accounting software packages to develop the reporting requirements. However, this would require more time, meaning that including these proposals in the omnibus tax bill scheduled for introduction in August this year is not feasible. Subject to your agreement, we propose to undertake consultation with software providers over the second half of 2022, with a view to including the necessary legislative amendments in a tax bill to be introduced in early 2023.

47. We do not recommend applying the four-year time bar to returns of ASC and net capital gains. If these returns were time barred, it would mean that when the

claimed amount of ASC or net capital gains became relevant (that is, a transaction occurred utilising these amounts, such as a liquidation or share repurchase) it could not be challenged by Inland Revenue in most cases (as more than four years would likely have passed by that time). We note that *not* applying the time bar to these returns would be consistent with the existing approach for imputation credit account returns which are also not subject to the time bar.

Personal services income attribution (proposal 3)

48. The Income Tax Act 2007 contains an attribution rule for income from personal services. The attribution rule prevents an individual avoiding the top personal tax rate by diverting income to an associated entity. Under the attribution rule, an amount of income of an associated entity is attributed to the working person.

49. The attribution rule currently 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 the following threshold tests are met:

    49.1 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 Discussion Document as the "80 percent one buyer" test.

    49.2 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 percent one natural person supplier" test.

    49.3 The business does not have "substantial business assets" used to derive the associated entity's income from personal services. "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 (gross) income from services for the income year.

    49.4 The working person's net income (including the net income of the associated entity) for the income year is more than $70,000.

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

Proposals

51. The discussion document proposed to remove the "80 percent one buyer" test that applies for the attribution rule. As possible further options, it also suggested:

    51.1 reducing the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent;

    51.2 increasing the $75,000 threshold in the substantial business assets test – the Discussion Document suggested $150,000 and $200,000 as two possible options; and

    51.3 excluding the value of passenger and luxury vehicles from the calculation of business assets except where the business is a transportation business.

Submitters' views

52. Almost all those who commented on the proposed changes to the personal services attribution rule opposed the measures, especially the proposed removal of the 80 percent one buyer test and the suggested reduction in the threshold for the 80 percent one natural person supplier test. The combined effect of the suggested changes was seen by submitters as a significant expansion of the scope of the rule.

53. A common criticism was that the proposed solution does not entirely align with the stated problem or rationale behind the proposal. Several submitters considered that something more targeted at the problem of inadequate shareholder salaries or dividend would be more appropriate, rather than "repurposing" the attribution rule. Note that shareholder loans will be considered as part of tranche two of the work on integrity measures.

Rationale for proposed change

54. Submitters noted that the original purpose of the attribution rule was to ensure that "quasi-employees" could not avoid having their income over $70,000 taxed at the then-top personal tax rate[6] by earning the income in a company or trust, and that the rule in its current form is appropriately targeted at this type of scenario. Submitters were concerned that repurposing of the attribution rule would affect many small businesses which have chosen a corporate vehicle for legitimate commercial reasons. They pointed out that the 28% company rate is a deliberate policy setting intended to encourage business activity and investment, and people who are taking on the risk of being in business and who have chosen a corporate form should not be taxed on the income of the company at their personal level.

55. Several stated that there are good commercial reasons for companies to retain earnings, including funding business expansion and investment in new assets. They felt small business owners should be entitled to reinvest retained earnings in their companies without being subject to tax at their marginal rate.

56. At least one submitter also pointed out that effectively imposing a higher tax rate on small companies is at odds with other recent policy measures in New Zealand aimed at supporting small businesses, such as the business continuity test that enables losses to be carried forward in some instances when a company is sold. Another submitter considered the proposal to be contrary to the approach taken by Australia, which has introduced a lower corporate rate for small and medium businesses.

57. Most also felt that the proposed changes are unnecessary and stated that there is no evidence to justify the proposed approach. They were of the view that the courts have been effective in countering tax avoidance, and that existing case law precedents and Inland Revenue guidance on the matter should be sufficient. A couple of submitters suggested that alternative interventions could instead be taken, such as codifying in law minimum market-based levels of remuneration for working persons or, alternatively, providing guidance on this, although one was careful to state that they did not favour that approach either.

58. As an alternative to the proposals, one submitter suggested exploring an excess retention tax. Note that consideration of excess retention tax is currently planned for tranche two.

[6] At the time of the attribution rule's introduction in 2000, the top marginal tax rate of 39% applied to income earned over $70,000.

Impacts of proposal

59. Submitters said that the proposed changes would:

    59.1 introduce competitive distortions between small personal services businesses and other businesses who are not subject to the proposals;

    59.2 increase compliance costs;

    59.3 reduce the ability of small personal services companies to reinvest retained earnings in new assets, and thus will undermine business resilience and growth and stifle businesses' recovery from the disruption caused by the COVID-19 pandemic.

Substantial business assets test

60. Submitters felt that the monetary thresholds suggested in the Discussion Document for the substantial business assets test ($150,000 and $200,000) were too high and not based on sound reasoning. One submitter said that, if anything, the thresholds should be reduced, as many personal services businesses are heavily reliant on IT and the cost of IT has not increased to the level to make the suggested thresholds realistic. One submitter said the maximum increase in the $75,000 threshold should be to $125,000. Another said the suggested $200,000 threshold in particular was much too high, especially for businesses run by tradespeople or specialists.

61. Some submitters took issue with the proposed exclusion of motor vehicles from the asset calculation. Others requested clarity on which assets would be captured by the test, including the definitions of "luxury vehicle" and "passenger vehicle".

62. One submitter suggested that the substantial business assets test should not be limited to assets owned by the business and that an appropriate test would instead be based around whether substantial infrastructure (including staffing and leased assets) is required to operate the business.

Net income of working person test

63. The Discussion Document did not propose to increase the threshold for the "net income of working person" test (currently $70,000) but invited submissions on whether the threshold should be increased. Submitters were generally in favour of increasing the threshold from $70,000 to $180,000.

Officials' view

64. The current personal services rule is essentially a quasi-employment test capturing only situations where a company's income is largely derived by selling a single person's personal services to a single buyer. The proposal would remove the 80 percent one buyer test and so would mean that companies selling a person's services to multiple buyers could be subject to the rule if they do not meet one of the exemptions. This would mean that a wide range of small personal services companies, from plumbers and builders to accountants, lawyers and IT contractors, could be subject to the rules.

65. Based on the information that we currently hold and applying a number of assumptions (including the doubling of the fixed asset threshold to $150,000), we estimate that the widening of the rule could apply to approximately 7,500 businesses earning between $70,000 and $180,000 per annum and could apply to approximately a further 500 businesses earning over $180,000 per annum.

66. Submitters have argued that the proposed widening of the rules is overreach and creates additional compliance costs for small businesses. The changes could capture around 8,000 businesses and could require the attribution of up to $450 million of income retained in companies. This income would then be subject to a top-up tax of 5% (28% to 33%) or 11% (28% to 39%). We note that these numbers are indicative only and that the actual resulting attribution is likely to be lower.

67. While the changes would significantly widen the rules, we consider that this is appropriate given all the impacted businesses earn at least 80 percent of their income from the sale of the services of one person. The income of the company is therefore strongly linked to the efforts of that one person and their remuneration should reflect that.

68. Widening the rule would also reduce the horizontal equity issue that exists between unincorporated sole traders and sole traders using a company structure by treating them similarly. However, it would also create a horizontal equity issue between personal services companies based on whether they have one or more people providing the services. The distinction between companies selling services largely provided by one person and companies with more than one person acting as a service provider can be justified having regard to the amount of control the single service provider is likely to have on the decisions made by the company. Where there is more than one provider there is likely to be a natural tension that reduces the risk of the retention of too much income as the different providers are incentivised to seek their share of the earnings.

69. Submitters also argue that it would be unfair to require these businesses to pay tax at the person's marginal tax rate on income that they want to reinvest in the business while businesses not caught by the rule can reinvest income having only been subject to tax at the 28% company tax rate. We consider this to be a legitimate concern and therefore would like to work with stakeholders on ways to address this issue. One option could be to allow a percentage of the income to be retained in the company. For example, the rule could be designed not to apply if at least 80 percent of the income had been distributed to the person who is the service provider.

70. Submitters have also argued that the proposed changes do not appropriately target people avoiding the 39% tax rate. This argument reflects a view held by some submitters that any changes made as part of this project should only relate to the 39% tax rate. The current attribution rule applies when the net income of the working person is at least $70,000, so the rule applies for taxpayers on the 33% personal rate as well as those on the 39% rates, with both of these rates being much higher than the 28% company tax rate.

71. To narrow the scope of the rule and reduce compliance costs, the rule could be made to apply only where the net income of the working person exceeds $180,000. This would reduce the estimated number of people that the rule would apply to from about 8,000 to about 500. On the other hand, it would also allow some people who earn over $70,000 but less than $180,000 to defer tax of up to $5,500 by retaining the income in the company. Changing the threshold to $180,000 raises fairness concerns and reduces potential attribution of corporate income by $250 million.

72. Options to address the concerns about the ability to retain income for reinvestment in the company may also reduce compliance costs and consequently will influence the analysis of whether it would be better to limit the rules to those with income exceeding $180,000. Therefore, we would like to explore these options before determining whether there is a case for narrowing the rules in this way.

73. Lastly, the Discussion Document proposed increasing the $75,000 threshold for the substantial business assets test, which has remained the same since the introduction of the rules in 2000. There is a case for increasing the assets threshold although the proposed exclusion of luxury vehicles is less easily defined. Our ability to define luxury vehicles in a way that can be practically administered may influence

decisions on whether to increase the substantial business assets threshold. Further work is required on the design of the changes and it would be beneficial to test the proposed design with submitters.

74. We propose to develop the design of the rules, taking into account the feedback received in submissions and Ministers' feedback so that we can then consult again on a more detailed proposal. This would allow submitters an opportunity to identify any specific issues with the updated proposals. Proposed legislation could be introduced early in 2023.

Financial implications

75. We previously advised that the share sales proposal in the Discussion Document might collect approximately $50 million in revenue per annum (T2021/277; IR2021/063 refers). However, the amount of revenue it would collect depends on the nature of the transactions undertaken in a year and could vary significantly from the estimated $50 million. At the time of the estimating the revenue impact, the proposal was expected to apply from 1 April 2023 but the revenue estimate was not included in government forecasts.

76. While narrowing the initial proposal to apply only to related party transactions would on the face of it reduce the expected additional revenue, the potential extension of the related party proposal to cover transactions that also shelter future income would at least partially offset this reduction. The overall impact is not able to be estimated until the design of the proposal is more developed. Officials will report back with the financial implications when seeking agreement on the final detailed design later this year. This would occur prior to the Budget Policy Statement so any additional revenue could be considered as part of that process.

77. As this related party measure would be a measure targeting specific transactions, it could be made to apply from the date of enactment or an earlier date such as the date of the introduction of the relevant bill. If it were included in a bill early next year, the introduction date could be around March 2023, while enactment would be likely to be around September 2023.

78. We are proposing to do further work to consider a wider rule for third-party share sales but note there are a number of outstanding issues with this to resolve. If progressed, such a rule would be unlikely to apply until 1 April 2024 or 2025 (depending on the timing of legislative changes). We would advise you on the fiscal implications of such a rule at a later date.

79. The personal services attribution rule changes would potentially capture around 8,000 companies and could cause attribution of up to $450 million. Tax on this could be up to approximately $36 million. We note that some of this income will be paid out as dividends so this, to an extent, will just be a timing difference. However, there will also be some permanent differences if income is distributed through trusts or retained in the company and the shares of the company are sold. Changes to reduce the impact of the rules would reduce the figures from these initial estimates.

80. The recording ASC and capital gains proposal is intended to assist with compliance and does not have any direct financial implications.

Next steps

81. We are scheduled to discuss the recommendations in this report at the joint Ministers' meeting on 2 June.

82. You previously agreed to progress these integrity proposals in the next omnibus tax bill scheduled for introduction in August 2022 (T2022/106; IR2022/013 refers). As

discussed in this report, further time to consider the feedback from submissions and refine the proposals would be beneficial. There is the risk that proceeding with legislation in the August tax bill would result in unintended consequences, including affecting people that are not intended to be impacted. Providing additional time would also allow us to gather data to better determine the impact of the changes, including the fiscal implications.

83. We instead recommend taking more time to refine the proposals with stakeholders and include the necessary changes in a tax bill scheduled for introduction in early 2023. If you agree to this timeframe, we will report to you in August or September with more detailed proposals and an attached draft issues paper for further consultation on more detailed proposals.

84. If you wish to proceed with any of the proposals at a faster pace, we can discuss how that might be achieved in the time available. To proceed with legislation in the August tax bill at introduction would require Cabinet approval for the final policy recommendations by 4 July.

85. We also seek permission to update stakeholders once decisions have been made on the progression of this work.

86. This would then be followed by advice on tranche two of this work which considers shareholder loans, excess retention tax, trust taxation and, depending on your decisions, a wider rule covering share sales to third parties. This advice is reliant on information from the additional trust disclosures, due to be received by the end of March 2023. The resulting analysis and advice will therefore not be available until later in 2023.