



POLICY AND REGULATORY STEWARDSHIP


Tax policy report: Update on integrity workstream

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|------------------------|----------------|-----------------------|--------------------------|
| Date: | 18 August 2022 | Priority: | High |
| Security level: | In Confidence | Report number: | IR2022/352 T2022/1837 |

Action sought

| | Action sought | Deadline |
|---------------------|---------------------------------|-----------------|
| Minister of Finance | Agree to recommendations | 25 August 2022 |
| Minister of Revenue | Agree to recommendations | 25 August 2022 |

Contact for telephone discussion (if required)

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|--------------|--|------------------|
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18 August 2022

Minister of Finance
Minister of Revenue

Update on integrity workstream

Purpose and recommendations

1. This report gives you an update on the integrity workstream and makes recommendations for next steps. Importantly, the recommendations should be considered alongside the report on [s 9\(2\)\(f\)\(iv\)](#)
2. We previously recommended that work on specific integrity measures to address some of the problems with misalignment be progressed in stages (T2021/277, IR2021/063 refers). However, following a public consultation process and further consideration, we have identified several risks with proceeding with this work [s 9\(2\)\(f\)\(iv\)](#) . We therefore recommend stopping this work on legislative changes for the next tax Bill in favour of a wider discussion to clarify direction on how to address misalignment.

Background

3. In 2020, a new top personal income tax rate of 39% for income earned over \$180,000 was introduced. The motivation for this reform was to raise extra revenue in a way that is progressive and does as little as possible to increase taxes on low to middle income earners.
4. We have provided you with a number of reports on the general issue of a lack of coherence in the tax system, focussing on the different tax rates that can apply to income, depending on whether the income is earned from personal services, dividends or investment, through companies, trusts or portfolio investment entities (PIEs) (see in particular *Tax policy report: Integrity of the 39% top personal income tax rate* T2021/277, IR 2021/063).
5. In March 2022, a Discussion Document proposing company integrity measures aimed at addressing some of the problems with misalignment was released. Following consultation on the proposals, we reported to you in May with a recommendation that these measures be progressed in a tax bill to be introduced in early 2023 to allow more time to consult further on the changes (T2022/1166, IR2022/283 refers).
6. The current focus for integrity measures has been on company issues (including share sales and personal services provided through companies). We had previously suggested further steps to enhance company tax integrity and rate differential issues across the tax system (including the PIE and trust rates) could be progressed in two subsequent tranches of work. However, feedback has made it clear that it is difficult to make these changes regarding company issues when the overall direction of changes has not been determined.

Discussion Document released in March

7. The Discussion Document *Dividend integrity and personal services attribution* released in March this year dealt with two issues with income earned through a company. These issues were:
 - 7.1 that in a sale of a company with retained earnings, the selling shareholders can effectively receive those retained earnings without paying tax at the shareholder level – the retained earnings will thus be taxed at no more than the 28% corporate tax rate (and possibly less, for example if they are from non-resident subsidiaries).
 - 7.2 that a person earning income from personal services can ensure that the income is taxed initially at only the corporate rate, and at only the trustee rate when distributed, by using a personal services company, and that this issue is only partially addressed by the current personal services income attribution rule.
8. The paper also proposed that companies be required, on a prospective basis, to 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.

Stakeholder feedback on proposals

9. The two proposals outlined in [7.1] and [7.2] were strongly opposed in consultation. Some stakeholders expressed concern about the breadth of the changes that were envisaged because important decisions have yet to be made on the broad direction of tax changes that were envisaged in later tranches.
10. Stakeholders were also concerned that the rationale for the proposed changes was unclear. Specifically, that the ability of people to pay tax at the corporate rate is the result of the structural tax settings rather than any deliberate attempt to avoid the top personal tax rate.
11. Some stakeholders considered the share sales proposal as akin to a capital gains tax.

Share sales proposal

12. In response to submissions, we recommended developing a targeted rule applying to related party share sales for inclusion in a tax bill in early 2023, to deal with the transactions that are the most likely to be specifically tax motivated.
13. In the process of developing this proposal and discussions with a number of stakeholders we have become aware that there is a lack of understanding about longer term directions which make it difficult to legislate rules ahead of a wider consideration of the tax framework underpinning the taxation of companies and shareholders.
14. While a targeted related party share sales rule is intended to ensure shareholders pay the appropriate amount of tax, it will also introduce complexity and boundaries within the tax system that could distort people's behaviour. The possible distortionary effects were a key concern raised by stakeholders, in particular the impacts on transactions that are done for commercial or practical reasons rather than being motivated by tax (for example, the way some family businesses are passed down to the next generation).
15. Distortions may be acceptable if the rules prevent people structuring share sale transactions in a way that results in no top-up tax being payable when value is

extracted from a company. However, any rule would need to be progressed carefully to ensure it has a clear purpose, integrates with the current anti-avoidance dividend stripping rule, and that unintended consequences are minimised. This is particularly important as any work in this area will be met with intense opposition from those impacted and could draw considerable media attention and public comment.

16. s 9(2)(f)(iv)

Personal services proposals

17. In the May report, we also recommended 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 competitiveness distortions.

18. The proposal would expand the current rule which is targeted at service providers in quasi-employment situations (supplying services to one client). The proposed change would mean that individuals providing personal services to multiple clients via a corporate structure will be required to pay tax at their marginal tax rate (assuming there are no significant assets).

19. A wide range of small personal services companies could be caught by the personal services attribution rule, from plumbers and builders to accountants, lawyers and IT contractors. It is difficult to estimate how many service providers could be impacted by these changes, however, we previously estimated this could be around 8,000 service providers.¹

20. Submitters were concerned that, unlike the current rule, the proposed expansion of the personal services attribution rule does not have a clear purpose and would put businesses caught by the rule at a competitive disadvantage. Specifically, these businesses would not be able to retain earnings taxed at 28% in the company as a way of investing in and growing the business.

21. We have been considering ways of allowing some level of earnings retention within the business, such as excluding businesses if they distribute at least 80 percent of earnings. This goes some way to address concerns raised by submitters. However, introducing a threshold like this is somewhat arbitrary and will likely distort behaviour.

22. s 9(2)(f)(iv)

s 9(2)(f)(iv)

23. s 9(2)(f)(iv)

24.

¹ Including doubling the threshold for the substantial business assets test to \$150,000.

s 9(2)(f)(iv)

25.

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Financial implications

27. Suspending work on a related party share sales rule and changes to the personal services attribution rule will defer the additional revenue which would have resulted from these changes. The amount raised by these proposals would depend on their final design. Initial estimates suggested up to \$50 million per annum for a wider share sales rule (not the more targeted rule) and \$36 million per annum for changes to the personal services attribution rule, but these estimates are highly uncertain.

Recommended action

We recommend that you:

1. **agree** to defer work on the proposed targeted rule applying to related party share sales s 9(2)(f)(iv)

Agreed/Not agreed

Agreed/Not agreed

2. **agree** to defer work on the proposed changes to the personal services attribution s 9(2)(f)(iv)

Agreed/Not agreed

Agreed/Not agreed

3. **discuss** with officials the process and timing for further advice on the direction of the tax system's structure, including dealing with the challenges of misalignment.

s 9(2)(a)

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