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29 April 2022

Dividend Integrity and Personal Services Income Attribution
c/- Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
PO Box 2198
Wellington 6140

Dear Sir/Madam

Re: Dividend Integrity and Personal Services Income Attribution

I am writing to you regarding the discussion document entitled '*Dividend Integrity and Personal Services Income Attribution*' (referred to as "the Discussion Document"). Specifically, the primary focus of our submission is on the following two policy areas:

1. Shareholders being taxed on the sale of shares in a company to the extent that the company (and its subsidiaries) has retained earnings; and

2. The changes to the personal services company rules that effectively remove when small businesses can use the lower company tax rate.

BusinessNZ accepts that the increase in the top personal tax rate to 39% on 1 April 2021 has meant that the potential for some type of avoidance to take place is heightened. Therefore, in principle we do not have an issue with Inland Revenue investigating certain aspects of tax policy that may be affected by a higher top personal tax rate.

However, in this instance, we believe that the proposals by Inland Revenue go far beyond what the business community would typically expect in terms of pragmatic and justified options to minimise avoidance measures. Instead, they represent a significant regulatory overreach that will likely create several unintended consequences that will directly harm many businesses, particularly small to medium sized enterprises.

Regarding the two issues outlined above that are discussed in the Discussion Document, BusinessNZ, along with the Corporate Taxpayers Group (CTG), sent a joint letter to the Ministers of Finance, Revenue and Small Business on 28 April that specifically outlined the broad concerns of the business community, along with strongly opposing the proposed changes. The joint letter is attached to this submission.

Recommendation: That Inland Revenue take into account the views expressed in the joint letter by CTG and BusinessNZ that was sent directly to Ministers.

We believe the letter accurately covers BusinessNZ's concerns, so we do not intend to repeat what is outlined in it. However, there is one additional point we would like to make for Inland Revenue to consider.

Future steps

As mentioned in the Discussion Document, the review of the current settings is being progressed in tranches. Tranche one sees the current settings being examined, while tranche two will consider trust integrity and company income retention issues. Paragraph 1.18 of the Discussion Document points out that "*Inland Revenue will be receiving more specific information from trustees for the 2021–22 and later income years under provisions in the recently enacted amendments to the personal income tax rate legislation. This additional information could help to inform in more detail how trusts are used and what measures could be considered to prevent under-taxation from the use of trusts*." Following that, paragraph 1.20 points out that "*a possible tranche three could consider integrity issues for the taxation of portfolio investment income, such as Portfolio Investment Entity (PIE) taxation*." Therefore, beyond the current tranche, a number of policy decisions still need to be worked through in regard to integrity measures associated with supporting the 39% personal tax rate.

Given the broad and consistent position of the business community that runs contrary to what Inland Revenue is proposing with the current tranche, BusinessNZ believes future tranches require greater input from the business community during their early phases of policy development.

We support the release of discussion documents/issues papers as a way in which the views of submitters can be taken into account before any subsequent legislation is brought before Parliament. However, there are instances where additional early testing of ideas/proposals before a consultation document is released would greatly the quality of the policy process. While we understand that timing is often a critical factor when assessing how much consultation can be undertaken, we believe early and meaningful discussions with groups and organisations that typically have a strong interest in the issue can save considerable time later down the track. Therefore, BusinessNZ would like to see Inland Revenue undertake a greater level of early and meaningful consultation regarding the next tranches of the policy process.

Recommendation: That Inland Revenue undertake a greater level of early consultation regarding the next tranches of the policy process.

Thank you for the opportunity to comment, and we look forward to further developments.

Kind regards,

Steve Summers
Economist
BusinessNZ

Corporate Taxpayers Group

BusinessNZ
GROWING PROSPERITY AND POTENTIAL

28 April 2022

Hon Grant Robertson
Minister of Finance

Hon David Parker
Minister of Revenue

Hon Stuart Nash
Minister for Small Business

Dear Ministers

By email

DIVIDEND INTEGRITY AND PERSONAL SERVICES INCOME ATTRIBUTION DISCUSSION DOCUMENT

Introduction

The Corporate Taxpayers Group and BusinessNZ are writing in respect of the Government Discussion Document "Dividend integrity and personal services income attribution".

As representatives of Business, we are doing so because we are concerned that the dividend integrity measures proposed in the Discussion Document:

- are not justified by their stated objective of limiting the ability of individuals to avoid the 39% (or 33%) tax rate, since that objective can be achieved by enforcement of the existing law. Inland Revenue has in the past two decades had a high success rate before the courts in cases involving alleged avoidance of the top personal tax rate and has settled numerous cases with the benefit of those case law precedents. It is unclear why Inland Revenue now says (as justification for the Discussion Document proposals) that it lacks the resourcing to apply the same laws it has successfully enforced in the past;

- will potentially apply to all business sale transactions, whereas they are more appropriately limited to internal restructuring which avoids the 33% or 39% tax rates, and even then, only if it is established that there is a compliance problem which cannot be solved with Inland Revenue's existing legislative tools (including the existing avoidance, dividend and fringe benefit tax rules) and the audit and data analytic capabilities unlocked by its new sophisticated computer system;

- would impose new costs and complexities on many businesses, the vast majority of which are not engaged in the tax avoidance practices to which the Discussion Document refers;

- would result in some cases in more onerous tax consequences (and greater potential for distortion of economic activity) than would arise under a capital gains tax (which the Government ruled out). For instance, the Discussion Document proposals would result in tax payable when a business is sold at a loss (see example 1 in the Appendix);

- would (given the preceding point) cut across existing tax policy settings that were put in place to remove tax-related barriers to bringing new owners into a business (including the business continuity test that enables losses to be carried forward when a company is sold if a business continuity test is met) and to enabling New Zealand businesses to compete internationally;

- will result in a number of other unfair outcomes, as illustrated by the examples in the Appendix.

We are also concerned that the proposed changes to the personal services income attribution rules will take the existing rules far beyond the "quasi-employment situations" which were originally contemplated when the rules were enacted in 2000. Instead, any labour-intensive small business with multiple customers, such as tradespeople, or (for example) a one or two-person hairdresser or beautician business, could be caught by the proposals.

The proposals could especially disadvantage such businesses while in their start-up phase, during which most of the income comes from the work of the founder and the business may not (yet) have substantial business assets. The founder may wish to retain profits in the company in order to acquire more equipment and take on more staff, but would be taxed at the 33% or 39% rate on profits they retain, while their larger competitors will be taxed at 28% on profits they retain. The proposals would, therefore, tilt the playing field against small labour-intensive start-ups.

Conclusion

Our respective bodies are concerned that the proposals in the discussion document represent a significant overreach and will apply far wider than transactions which have been deliberately entered into in order to avoid the 39% tax rate.

If it is determined that the proposed measures are needed at all, they should be significantly scaled back to ensure they are targeting only the mischief in question, and only once it is established that there is a compliance problem which cannot be solved with Inland Revenue's existing legislative tools and its sophisticated computer system.

Yours sincerely

John Payne
For the Corporate Taxpayers Group

Kirk Hope
For Business New Zealand

We note the views in this document are a reflection of the views of the two business groups and do not necessarily reflect the views of individual members.

APPENDIX

Proposals would impose new costs and complexities on businesses

Part I of the Discussion Document proposals would recharacterise the proceeds of sale by a controlling shareholder of shares in a company, by deeming part of the proceeds of sale to be a dividend. The proposals would affect the owners of the thousands of SMEs across the country who may wish to sell any level of shareholding in their business.

It is the view of our organisations that in many instances the outcomes under these proposals are equal to, or worse than, the outcomes under a comprehensive capital gains tax.

Below are some examples to illustrate the potential impact of the proposals:

1. A small business owned by a single shareholder had a cost base of $300,000. The business had been successful prior to the pandemic, and the company has retained earnings of $150,000. The pandemic has adversely affected the business's future prospects and the owner, who has reached retirement age, sells the shareholding for $200,000. The owner, therefore, sells at a loss of $100,000, but (under the proposals) would have income for tax purposes of $150,000.

2. A profitable business which reinvests its profits into growing the business by expanding or purchasing new assets will be deemed to provide a dividend to a majority shareholder in the event that any shares are sold; this is regardless of the fact that profits were reinvested/spent by the business.

3. Different owners have different outcomes based on blood relationships and when they exit the business:
   a. Company F is equally owned by Shareholders X, Y, and Z. The shareholders are all siblings. Shareholder Z wishes to sell their share of Company F and Shareholders X and Y agreed to purchase the shares to result in them owning 50% of the shares each. Shareholder Z is deemed to receive a dividend equal to 1/3rd of the retained earnings in Company F because Shareholder Z is deemed to be a controlling shareholder due to being a sibling to the other shareholders.
   b. Company G is equally owned by Shareholders U, V, and W. The shareholders are all friends. Shareholder W wishes to sell their share of Company G and Shareholders U and V agreed to purchase the shares to result in them owning 50% of the shares each. Shareholder W has no tax consequences of selling the shares.
   c. Company G is equally owned by Shareholders U and V. Shareholder V sells their shares to Shareholder U. Shareholder V has no tax consequences of selling the shares.
   d. Company G is owned by Shareholder U. Historically Company G also had 2 other shareholders (V and W). Shareholder U decides to sell Company G to an unrelated party. Shareholder U is deemed to receive a dividend of the full balance of retained earnings in Company G.

4. Company I is a start-up company owned by Shareholders R and S. Company I has invested heavily in research and development. Company I has benefited from the R&D Tax Incentive, receiving $1m (and consequently $1m of imputation credits). While Company I has not yet reached break-even point or become profitable, its future prospects are positive; as such Shareholders R and S wish to sell the business to pursue a new innovative idea. Shareholders R and S are deemed to receive a dividend of up to $3.57 million ($1 million ICA balance divided by the company tax rate) when they sell Company I to its new owners.

The above examples demonstrate the clear over-reach of the rules and the potential for inappropriate results based on slightly different fact patterns; we can provide more examples if required.