TAXPAYERS' UNION

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Dividend integrity and personal services income attribution
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Submission on dividend integrity and personal services income attribution

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About the Submitter

1. This submission has been prepared for the *New Zealand Taxpayers' Union* by OliverShaw, a specialist tax advisory practice founded in 2011 by Robin Oliver MNZM LLB MA and Mike Shaw CA.

2. Founded by David Farrar and Jordan Williams in 2013, the *Taxpayers' Union's* mission is Lower Taxes, Less Waste, More Transparency. We enjoy the support of some 170,000 registered members and supporters, making us the most popular campaign group championing fiscal conservatism and transparency. We are funded by our thousands of donors and approximately five percent of our income is from membership dues and donations from private industry supporters.
3. We are a lobby group not a think tank. Our grassroots advocacy model is based on international taxpayer-group counterparts, particularly in the United Kingdom and Canada, and similar to campaign organisations on the left, such as Australia's Get Up, New Zealand's ActionStation, and Greenpeace.
4. The *Union* is a member of the World Taxpayers Associations - a coalition of taxpayer advocacy groups representing millions of taxpayers across more than 60 countries.
5. We give permission for Inland Revenue to publish this submission.

Introduction

6. The government discussion document ("the Document") proposes three changes. This submission is on two of the proposals:
    a. Shareholders being taxed on the sale of shares in a company to the extent that the company (and its subsidiaries) has retained earnings
    b. The changes to the personal services company rules that effectively remove when small business can use the lower corporate tax rate.
7. We strongly oppose both these proposals as in effect, they amount to additional taxes on small businesses. The case for such ad hoc measures being necessary to buttress the 39% income tax rate is not made in the Document.
8. Instead, these measures would prevent small businesses from using retained earnings taxed at the corporate tax to invest in the firm's plant and machinery and other necessary business assets.
9. Taxing share sales on the gross value of the underlying retained earnings, in effect, deems all such earnings to be distributed to the vendor shareholder at the time of the share sale. However, the earnings are still invested in the firm funding business assets. There is no justification for deeming this to be income of the vendor shareholder when it is still invested in the business.
10. Applying this rule to all controlling shareholders including shareholders who "act together" would mean the rule would apply to most family businesses. In effect they are then denied the 28% company tax rate for reinvested profits that other larger businesses have.
11. The current personal services attribution rule deems the income of a company that is in effect merely the single shareholder's employment income to be income of that shareholder and so is taxed at individual rates not the company rate. For the rule to apply currently:
    a. <u>80%</u> of the firm income must come from <u>one client</u>; and

b. The owner must generate 80% or more of the firm profits; and

c. The firm must have less than $75,000 in business assets.

12. The proposal is in effect to apply this rule to many family businesses that have fewer than two or three employees and business assets less than $150,000 to $250,000. This would cover many tradies and small contactors. They would be denied the ability to finance assets out of profits taxed at the 28% company tax rate. We say that is unfair and wrong.

Taxation of the sale of shares

13. The Government proposes that when a shareholder sells their shares, they will be taxed as a dividend on a portion of the shares if:

    a. they are a controlling shareholder owning more than 50% of the shares; or

    b. if they are "acting together" with other shareholders where they and the other shareholder control the company.

14. The taxable dividend will be the greater of:

    a. the shareholder interest in the retained earnings of the company (grossed up for imputation credits); or

    b. the quantum of imputation credits in the company (grossed up by the tax rate).

15. Our opposition with taxing the sale of shares is as follows:

    a. The stated problem is avoidance of the 39% tax rate. The proposals are not limited to such avoidance. (See: Problem definition)

    b. The proposal is, in many cases, a tax on the gross return from the sale of shares and therefore in some cases it will be on an amount that exceeds the economic income of the shareholder. (See: Taxation on gross proceeds)

    c. The proposals are not practical and therefore not workable. (See: Proposals are not practical)

    d. The practical effect of the proposals will materially impact on commercial transactions and in some cases result in commercial transactions now not occurring. (See: Economic distortion caused by the proposals)

Problem definition

16. The Document outlines how the Government is concerned about the integrity of the 39% tax rate for individuals.

    a. "The Government's <u>work on integrity measures to support the 39% personal income tax rate is being progressed</u> in tranches. Tranche one, which is the focus of this discussion document, concerns dividend integrity and income attribution measures" (page 5)

b. “The biggest area of concern relates to closely-held companies and trusts that are used to earn income on behalf of relatively high income individuals, particularly those who earn income that is taxed at the top personal tax rate of 39% (or who would have income taxed at the top personal rate if they earned the income directly rather than through an entity)”. (Para 1.7)

c. While the Government’s main concern is the integrity of the 39% tax rate, the proposals in this document can affect taxpayers at any personal tax rate in situations where some of or all their income is being earned through entities. (para 1.9)

17. The proposed solution is considerably wider than the problem as outlined above. While reference is also made to avoidance at the 33% tax rate, again the proposal is not limited to avoidance of these rates. As outlined below, the proposal is a tax on gross income and is unrelated to taxpayers who are on the 33% or 39% tax rates. For example, a widely held corporate which has no controlling shareholder is subject to these rules while its tax rate is 28%. Further all its shareholders might be portfolio investment entities, again this is of no relevance to the stated problem definition.

18. As detailed further below, the proposal is a tax on the gross proceeds and not on the net gain of the shareholder. Taxing a shareholder on their gross sales proceeds has no relationship to their actual gain. For example, it is possible under the proposal that a shareholder sells shares at a loss however, under the proposal, they have taxable income. Again, this is not related to the avoidance of the 39% tax rate.

19. It is proposed that the measure not apply to the sale of shares in a listed company and the sale by non-controlling shareholders (unless they are acting together with other shareholders who control the company). If this is the right policy outcome for major shareholders, then it would seem logical it should apply to all shareholders. The document says it is not practical for non-controlling shareholders to undertake the detailed calculations, however as discussed below, we do not believe it is practical for controlling shareholders.

Taxation on gross proceeds

20. The proposal is to tax the shareholders interest on the greater of:

a. The retained earnings of the company

b. The grossing up of the imputation credits of the company

21. This is a tax on the gross proceeds and not on the net gain of the shareholder. It is clear from the Document that this the intended outcome. (Para 3.41)

22. This would result in absurd outcomes. For example, where the controlling shareholder acquired a company that already had retained earnings and subsequently sells those shares, the shareholder will be taxed both on retained earnings accumulated during the ownership of the shareholder *and* the retained earnings in the company when it was acquired by the shareholder (pre acquisition retained earnings). That amounts to double taxation.

23. Not only would this mean that a person is taxed on retained earnings derived before they had an interest in the company, but they are also taxed if the shareholder sells the shares at a loss.

a. In table format we provide the following examples where a company is acquired and then disposed of. In all the examples below, the gain (loss) on the sale shares is unrelated to the tax liability incurred by the shareholder:

Balance sheet at acquisition	example1	example2	example3	example4
Net assets of company	**130,000**	**130,000**	**130,000**	**130,000**
Shareholders equity				
Paid in capital	10,000	10,000	10,000	10,000
Capital gains	20,000	20,000	20,000	20,000
Retained earnings	100,000	100,000	100,000	100,000
Total shareholders equity/net assets	**130,000**	**130,000**	**130,000**	**130,000**
Cost to acquire the shares	**130,000**	**130,000**	**130,000**	**130,000**

Balance sheet at sale date				
Net assets	**130,000**	**80,000**	**180,000**	**110,000**
Shareholders equity				
Paid in capital	10,000	10,000	10,000	10,000
Capital gains	20,000	20,000	20,000	-
Retained earnings	100,000	50,000	150,000	100,000
Total shareholders equity/net assets	**130,000**	**80,000**	**180,000**	**110,000**
Sales value of shares	**130,000**	**80,000**	**180,000**	**110,000**
Gain over costs	**-**	**- 50,000**	**50,000**	**- 20,000**
Taxable income under proposals	100,000	50,000	150,000	100,000

24. The above examples are where a company is acquired and then sold. Unwarranted tax liabilities can arise when a company was incorporated by the shareholder and then disposed of. As noted para 3.41 of the Document states this is the intended outcome. An example of this is as follows:

Profits	138,889
Less tax at 28%	38,889
Profits after tax	100,000
Capital loss	- 50,000
Shareholder's funds/net assets	**50,000**
Sale value	50,000
Gain on sale of shares	50,000
Taxable income	100,000

25. Paragraph 3.41 states that if the loss was allowed this would effectively allow a deduction for capital losses. The problem with the above, is that it is taxing gains that never eventuated. Further, if the company was first liquidated and the shareholder then sold the net assets of the company for $50,000 then the tax that arises under the proposals would not arise. This is an absurd result. No tax liability would arise if instead of selling the company it is liquidated and then the distributed assets sold. The alternative of liquidating the company will obviously incur substantial compliance costs in undertaking the liquidation, the need to transfer of commercial contracts and the overall added complexity.

26. A similar result arises under the alternative of grossing up the imputation credits. Using the above example, as opposed to a capital loss if there were simply non-deductible losses, such as revenue expenditure that was not tax deductible, a similar result occurs. That is:

Profits		138,889
Tax at 28%		38,889
Profits after tax		100,000
Non-deductible expenditure	-	50,000
Shareholder's funds/net assets		**50,000**
Sale value		50,000
Gain on sale of shares		50,000
Retained earnings		50,000
Imputation credits		38,889
Gross up of imputation credits		138,889

27. Under the proposals, the taxable income is the greater of the retained earnings ($50,000) and the gross up of the imputation credits. Given the non-deductible expenditure the grossing up of the imputation credits gives rise to taxable income of $138,889 whereas the company was only sold for $50,000.

28. The above examples also highlight the effect of the shareholder deriving all the income in the year of sale. Consider an example where a company earns $150,000 each year. Each year the company pays a salary of $100,000 therefore leaving in the company $50,000 (before tax) to invest in stock, plant and machinery. After five years of retained $50,000 (before tax), the company will have retained earnings of $250,000 less tax of $70,000 (at 28%), that is retained earnings of $180,000. If the company is sold, at the end of year 5, the taxpayer will have total taxable income of $100,000 salary and $180,000 dividend. That is $280,000 of which $100,000 is taxed at 39% (the excess over $180,000). <u>In all the years the taxable and the company never had combined income over $180,000. In this case there is no issue of anyone avoiding the 39% tax rate but income is taxed at the 39% rate.</u>

Proposals are not practical

29. These rules come with substantial complexity and are not practical to implement or only implementable by incurring substantial compliance costs.

30. The proposal requires the calculation of the retained earning <u>at the time of sale.</u> This will require detailed financial accounts at the sale date during the income year when shareholding changes take place. In the situation where the controlling shareholder is progressively selling down to employees through the income year, this will require detailed accounts to be prepared throughout the income year. This comes at a substantial compliance cost or transactions will be aligned with income tax balance date or transactions will not occur at all.

31. The cost of detailed financial accounts also will require of level of precision that for many companies is only undertaken at year end. This includes:

    a. Depreciation calculations to shareholding change date.

    b. Physical stock takes.

    c. Accrual and provisions including calculation of tax liabilities, holiday provisions, shareholder salaries etc to the date of sale.

32. There will likely be a range of avoidance rules to prevent taxpayers artificially reducing retained earnings to reduce the tax payable by the sale of shares by major shareholders (such as the over-provision for expenses). The scope and breath of these rules is not yet known so it is not possible to provide detailed comments other than this will raise compliance costs.

33. The calculation of the imputation credits at the point of sale has also not been fully canvassed in the Document. This will likely need to be adjusted for tax liabilities post the sale or outstanding tax refunds. There is no comment on how tax liabilities from the last income year to the point of sale are to be treated. For example, if there are material profits from the last balance date but no tax has yet been paid with respect of that period, is some adjustment required?

Economic distortion caused by the proposals

34. Many companies initially start with insufficient capital. They accumulate capital through the retention of taxable income, that is retained earnings. The proposals in the Document will create a tax cost for many commercial transactions and as such it could create a barrier to undertaking ordinary commercial transactions. It is proposed that the tax will be paid when any controlling shareholder sells shares in the following situations:

    a. Introducing employees

    b. Introducing another partner

    c. Succession planning

35. When introducing the above shareholders, the major shareholder will be taxed on the retained earnings portion of the shares being sold. Most small and medium size companies build capital by retaining profits so that the level of retained profits will be significant, especially if retained earnings are accumulated over a number of years. The retained earnings are likely to be invested in plant and machinery etc. necessary to operate the business.

36. When a controlling shareholder sells even a small portion of their shares there could be a significant cash liability even though the funds are still in the company. This could be a significant barrier for controlling shareholders selling shares to employees, new partners or combining businesses.

Conclusion to taxing the sale of shares

37. Conclusion:

    a. This is a significant tax imposition on the sale of many companies. While portrayed as taxing those avoiding the 39% tax rate, these proposals go much further and will impact shareholders that have never been on the 39% tax rate.

    b. For many small and medium size companies these proposals will create a barrier to introducing new investors, rewarding employees with shares and succession planning. This is a material economic distortion that is not discussed in the document.

    c. These rules will come with extreme complexity and therefore compliance costs.

Personal services attribution rule

38. It is also proposed to change the personal services attribution income. Where a company earns taxable income it is taxed at 28%. Generally, where the income from the company is derived from the <u>services of one person</u> and <u>80% or more of that gross income comes from one customer</u> and there are <u>no substantial assets</u> (costing greater than $75,000), then the income of the company is taxed at the person's individual marginal tax rate as opposed to the corporate tax rate. This is referred to as the personal services attribution income.

39. The personal services attribution rule was targeted "at people who would normally be regarded as employees" (para 6.4). More specifically this was aimed at structures where a single individual provides services income to one client/customer operating through a corporate structure to gain the advantage of the lower corporate tax rate.

40. <u>The proposed changes to the personal services attribution rules fundamentally change this to apply the rule to most small services business operated through corporate structures.</u> The rule will no longer be limited to contractors who are in substance employees.

80% of income from one client/customer

41. The first change is to remove the requirement that the company receives 80% or more of its income from one customer. This materially expands the rule from contractors operating through corporate structures to businesses. This is best demonstrated in example 8 in the Document. The Document states (papa 7.1, emphasis added):

> Example 8 illustrates how there <u>might also be an issue</u> when a taxpayer that performs personal services has multiple customers.

> **Example 8: Personal services business with multiple customers**
>
> Bill is an accountant who is the sole employee and shareholder of his company, A Plus Accounting Ltd. The company pays the 28% corporate tax rate on the income from accounting services provided to clients and pays a salary to Bill of $70,000. <u>Any residual profits are either retained in the company</u> or are made available to Bill as loans.

42. Currently, the personal services attribution rule will not apply to Bill as the company does not receive 80% of his income from one single client. From the facts, Bill is operating a business with numerous clients.

43. An obvious conclusion from the facts is that Bill is using the retained profits to finance debtors, computers, furniture and other fixed assets. Whereas other businesses can finance these business assets from tax paid profits at 28%, the proposal would mean that this is not available to Bill. <u>This is directly removing the corporate tax rate for small businesses. There is not even the necessity for Bill and the company combined to be earning over $180,000 when the 39% tax rate applies.</u>

44. The above example suggests that the profits may be advanced to Bill as a loan. There are comprehensive dividend rules to negate any tax benefit arising from such a structure of loans to shareholders. These comprehensive dividend rules have been a feature of the tax framework for a considerable period of time and there has been no suggestion they are not working correctly in removing any tax benefit. The tax benefit of the loan is not explained, neither is the application of the deemed dividend rules. There is simply no basis to suggest a change is required due to the loan.

45. It is submitted that the removal of the requirement to have at least 80% of the income from one client/customer is wrong.

Removal of the 80% individual supplier rule

46. The personal services attribution rule requires 80% of the "effort" to provide the services to come from one person (in the above example it is Bill). "Effort" is in proportion of the income of the business the one person derives.

47. It is proposed to reduce this "80% effort test" down to 50%. That is, the person providing the services currently has to provide at least 80% of the effort. It is proposed to reduce this down to 50%.

48. With the requirement that 80% of the income comes from one client (as above), the "80% effort test" makes sense. <u>With the removal of the requirement that 80% of the income comes from one client, the reduction of the "80% effort test" to a 50% test means that small service businesses with one or potentially two or three employees cannot access the 28% corporate tax rate.</u>

49. If there is only one shareholder employee providing the services, then the personal services attribution rule would naturally apply (whether an 80% or 50% effort test). Reducing the 80% effort test down to 50% means where the company has one, two or three employees (including the shareholder employee) then the rules will only apply if the shareholder employee is providing at least 50% of the "effort". This is obviously extremely subjective. It requires detailed analysis of whether the shareholder employee contributed at least 50% of the "effort" to generate the income of the company and in many cases this will not be measured.

50. If there is an accounting business with say one accountant and say two other employees, this business will be prohibited from retaining profits with the tax rate of 28% if the accountant generated 50% of more of the "effort" to derive the income. <u>Why such a business cannot access the 28% corporate tax rate when similar business with more employees can is not explained.</u>

51. For the reasons outlined above, we submit there should be no changes to the existing rules.

Substantial asset test

52. The personal income attribution rules do not currently apply if the business has substantial assets used to generate the services income. In most situations there is a $75,000 threshold when an asset becomes substantial and the personal income attribution rules do not apply if that threshold is exceeded. For example, a farming contractor that provides services such as cutting grass is not caught by the personal attribution rules if they have a substantial assets such as the tractor. Currently, they can access the corporate tax rate retaining profits at the 28% tax rate to repay the loan to buy the tractor.

53. There are two proposals with respect of this exemption from the personal services attribution rules. The first is to increase the $75,000 test to either $150,000 or $200,000 due to "the cost of business assets today." (para 7.7). The second proposal is to remove passenger vehicles or luxury vehicles (para 7.8).

54. There is no explanation for the increase in the threshold from $75,000 to either $150,000 or $200,000. There is no explanation what forms "the cost of business assets" noted above.

55. Removing "passenger vehicles" is also without policy rationale. If the substantial asset is a bus, it is unclear why the taxpayer cannot access the corporate tax rate to finance the cost of the bus. Likewise, if

the business is that of a shuttle van, there seem no policy rationale why such taxpayers will not be able access the 28% corporate tax rate for reinvested profits.

56. The proposed exclusion of luxury vehicles has even less policy rationale. First, there is no explanation when a vehicle would be classified as a luxury vehicle. The luxury vehicle does not seem limited to passenger vehicles and could therefore include "luxury" trucks, diggers or tractors. Why such a prohibition is required is not explained.

Conclusion to personal services attribution rule

57. Conclusion

    a. This is a significant change expanding the personal services attribution rule from contractors servicing a single client to small businesses servicing many clients. The case for the expansion is simply not made in the Document.

    b. There seems no justification for removing the 80% "effort" test to include small business with one, two or three employees.

    c. There is no justification to excluding passenger vehicles or luxury vehicles from the definition of substantial assets.

    d. These rules will come with extreme complexity and therefore compliance costs.

    e. These changes should not proceed.

Final comments

58. Together, these proposals disproportionately increase taxes on small businesses and in effect represent a substantial break from the Labour Party's pre-election promise to not introduce any new taxes beyond those in the Party's election manifesto.

Yours sincerely,
New Zealand Taxpayers' Union Inc.

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