New Zealand Law Society
Te Kāhui Ture o Aotearoa

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Policy and Regulatory Stewardship
Inland Revenue Department

By email: policy.webmaster@ird.govt.nz

Re: Dividend integrity and personal services income attribution – Government discussion document

1. The New Zealand Law Society | Te Kāhui Ture o Aotearoa welcomes the opportunity to comment on the Government Discussion Document *Dividend integrity and personal services attribution* (the **Discussion Document**).

2. These comments respond to the questions as set out in the Discussion Document. They have been prepared with the assistance of the Law Society's Tax Law Committee.

Part I: Shares

3. Overall, the Law Society does not support the proposals outlined in Part 1 of the Discussion Document. The proposal is, in substance, a capital gains tax – it recharacterises the sale proceeds of shares held on capital account as a taxable dividend. This is inconsistent with the Government's publicly-stated policy to not tax capital gains.

4. The proposal fails to recognise that a key distinction between what is a legitimate capital transaction with a third party, and a dividend stripping structure, is the lack of a motivation to strip out a dividend from the company. Sales of shares to third parties occur due to the decision by the shareholder to dispose of its capital investment. Therefore, this is not a dividend integrity issue.

5. The Law Society is of the view that it is not appropriate indirectly to enact a capital gains tax in this manner, whether intended or not, when it is known that such an effect would be contrary to stated government policy on capital gains tax. Further, describing the proposals as 'dividend integrity measures' may have inadvertently undermined consultation on what are significant proposals, the consequences of which may not have been appreciated by potential submitters.

6. There are other, significant, issues not considered in the Discussion Document that are essential to the design of the proposal and which should be consulted on. For example, the proposal, as described, would be retrospective as it would apply to the retained earnings of a company since the company was incorporated. Further, there is no consideration of any grandparenting, the effect on sale of shares on death, or the impact this proposal will have on domestic investment and productivity.

Questions

Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?

7. The Law Society does not agree that this is an appropriate policy outcome, and considers the proposal should not proceed, because:

    a. There are genuine commercial reasons for companies not distributing amounts to shareholders. These can include the need to reinvest retained earnings, to drive capital growth (i.e., payments expended on expanding the taxpayer's business, or the growth of a capital asset).

    b. Paragraph 2.23 of the Discussion Document implies that the increased balances of non-listed companies' imputation accounts are attributable to businesses deciding not to incur the tax which would arise from distributions, and instead looking to sell a company and access a tax-free capital gain.

        i. We consider this is incorrect. Whether a company pays a dividend and whether shareholders decide to sell their shares in a company is determined by a range of commercial factors, often outside of the control of the company or the shareholders. For example, changes in the investment market away from income generating assets towards capital growth stock.

        ii. A clear example of this is New Zealand's tech sector, which will generally not pay dividends to its shareholders, instead making the business decision to reinvest profits, to develop world leading technologies. If instead such companies are concerned with the tax bills that may arise when, say, a venture capitalist or angel investor makes an investment, they may be more inclined to distribute dividends regularly to avoid a lump sum tax charge.

    c. The experience of practitioners is that the purchaser in a transaction will often require the target to declare a taxable dividend immediately prior to the transaction, equivalent to the total amount of cash held by the company. This is commonly achieved by an agreed working capital statement in the sale and purchase agreement. Contrary to the Discussion Document's underlying premise, a vendor does not sell a cashed-up target to a third-party purchaser. This is because the purchaser of the shares does not want to pay 'cash for cash'.

    d. The proposed rule would in effect create a 'shadow' capital gains tax on shares otherwise genuinely held on a capital account that would not ordinarily be taxable. Imposing a tax on the sale of shares to third parties would create a financial penalty for entering a transaction and could prevent commercially beneficial transactions from taking place. This would be an example of tax policy unduly impacting commercial outcomes.

    e. The proposed rule is unnecessarily complex, and seeks to target a perceived risk that is not borne out in practice:

        i. It is not the experience of practitioners that taxpayers dispose of their share interests in order to access untaxed gains. Ordinarily, taxpayers dispose of their interests when they consider they can realise value on a capital asset that aligns with their investment horizon, or with a need to introduce new shareholders to the company, and not because there is a large sum of retained earnings on the balance sheet. There are existing avoidance rules in force to counter this issue,

and the Commissioner is known to be actively considering transactions of interest, as an operational matter.

ii. Moreover, the current proposal does not consider the many complexities associated with introducing what is, in effect, a form of capital gains tax – including:

- Whether any rollover relief would be available (i.e., upon the death of shareholder) and, in the event that no relief is allowed, whether the proposal would act as a form of inheritance tax on shares owned by relatives.
- The application of the proposal in the event of an internal reorganisation.
- The application of the proposal to employee share schemes.
- The conflict between the current proposal and existing regimes in the Income Tax Act. For example, the ability of New Zealand companies to receive as exempt income dividends from CFCs engaged in active business.
- How pre-enactment retained earning would be treated. Specifically, whether there would be a valuation date or whether the retained earnings of a business would be 'grandparented.'

8. In addition, the proposal will apply inconsistently to only New Zealand tax resident persons, as it is not currently proposed to apply to businesses owned by non-resident shareholders. This proposal may disincentivise local investments in New Zealand businesses by increasing the cost of investment, which has the potential to reduce productivity generally (particularly when coupled with the current tax rate for inbound investment).

9. Should the proposal proceed, the Law Society is of the view that this proposal should only apply to future acquisitions, for which taxpayers are aware that the capital gain of their shares would be taxed (and so the relevant return on investment can be accurately calculated). The proposal is retrospective as it taxes retained earnings arising prior to enactment and will impact the return on investments already made. Taxpayers have acquired shares on a capital basis expecting that the capital nature of the asset would be respected, especially so considering the Government's policy not to tax capital gains.

Should the scope of the proposed recharacterisation rule cover all of scenarios A, B, and C?

10. For the reasons outlined above, the Law Society does not consider that the rule should be introduced for any of the scenarios outlined in the Discussion Document.

11. Scenario A is covered by existing law. The Law Society considers that the tax legal landscape is already saturated. Adding a new rule that will overlap considerably with existing law is not desirable.

12. Scenarios B and C relate to arms' length transactions between parties that are not associated. These rules would add a level of complexity that would make business transactions unnecessarily more difficult to complete, could lead to a loss of business activity, the adoption of new business structures or tax-driven changes in business investment strategies.

Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?

13. The Law Society considers the proposed rules are too broad. Imposing a tax only on controlling shareholders seems to be somewhat arbitrary, and could create inequitable outcomes, as illustrated in the below examples:

    a. A business set up by two unrelated individuals, owning 51% and 49% respectively. The shareholding is based on the amount that was genuinely available by both parties to be invested into the business. Clearly in this case, there is an advantage gained by the 49% shareholder, because when they have reached their investment horizon and seek to realise a return on their capital asset, they will not be subject to the proposed rule. However, the 51% shareholder would be, and would likely receive lower capital return compared to the other shareholder despite owning a larger percentage of the company.

    b. A New Zealand investor which acquires more than 50% of the shares in a company, which had not previously had any one person (or group of related persons) with an interest of more than 50% (i.e., these proposed rules would not apply to the vendors, and there would be no step up in ASC etc). The company has been operating for the best part of 15 years, and has not paid a single dividend as all profits have been reinvested into the company's business. The investor holds the shares for 5 years, and no dividends are paid in this time. When the investor seeks to dispose of the asset, they will be taxed on 20 years of retained earnings, of which they were not a shareholder for 75% of the time.

       The Discussion Document does not contemplate whether the retained earnings created prior to the enactment of the proposal would be taxed in a scenario such as the above. Further, it does not contemplate whether retained earnings arising prior to the controlling shareholder obtaining a shareholding would be subject to this proposal.

14. In addition, the proposed application of the associate and 'act together' rules are too broad. If an 'act together' test like the definition in the hybrid rules is adopted, then the breadth of the proposal will be very wide, and likely beyond the scope of the intended objective of counteracting tax avoidance.

15. If the rules are to proceed, the Law Society considers a more appropriate threshold would be for application of the rules to those with more than 80 percent of the voting interests in the company.

Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?

16. As outlined, the Law Society does not agree with the proposed rules in principle.

What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two) and which of these approaches do you prefer? Is there an alternative approach you would suggest?

17. If the proposal is adopted, the Law Society suggests that the most appropriate quantification approach would be to calculate the deemed dividend on the lower of the grossed-up ICA balance and the sales price, for the following reasons.

18. We do not consider that retained earnings should be used to quantify the deemed dividend. Retained earnings is an accounting concept, and its computation is clearly governed by a set of accounting standards (i.e., GAAP or IFRS) and not taxable profits. There are a range of items that go into the computation of retained earnings that may not otherwise give rise to income

tax. For example, profit could include significant unrealised gains (e.g., property) that would not be taxed, which is clearly the case as there are adjustments made in tax calculations.

19. Another example is a profit in one accounting year which will be reversed in subsequent years (for example, a mark to market gain on a long-term supply contract). To then tax these amounts via the proposed rules could result in over taxation, and again encourage regular distribution of dividends which otherwise would have been reinvested into the business. Further, the flexibility of accounting rules and their inconsistent application could cause a range of issues. Recourse to tax concepts is desirable to ensure that the scope of this rule is not broadened due to changes in accounting standards.

20. ICA accounts will not always be reflective of undistributed earnings in a company. For example, deposits / withdrawals can be made from tax pools that would increase or decrease the ICA of a company. In addition, an ICA is predominantly impacted through provisional tax. Provisional tax, by its very nature a 'guesstimate.'[1] Ordinarily, provisional tax is overestimated to avoid UOMI and penalties. This could result in a shareholder paying more tax than would otherwise have been paid if regular dividends had been paid – again, this could encourage regular distributions of dividends and is not conducive to good business practice. Despite these drawbacks, if the proposal is to be adopted, we consider the grossed-up ICA balance to be the better of two difficult options.

21. To the extent these rules are implemented, it will be important any deemed dividend that would arise is capped at the cash proceeds, not the total sale proceeds, as this could result in a "dry" tax charge for the vendor.[2]

Do you agree with the proposed approach (outlined in Example 3) for calculating dividends and ASC adjustments for corporate groups?

22. Example 6[3] demonstrates the complexity of this proposal. Further, it only calculates the retained earnings based on the grossed-up ICA balance and does not demonstrate how the accounting retained earnings would be calculated. Therefore, we consider that the proposed approach outlined in Example 6 does not adequately explain the full impact of this proposal.

23. As noted above, and as noted in the Discussion Document, the ICA balance is not a perfect measure, and could result in over-taxation.

Is the approach outlines in Example 4 for a sale of one controlled company to another (existing) controlled company (potentially generating a deemed dividend from both companies) correct conceptually?

24. The Law Society notes that applying such a rule to activities within a corporate group will likely impact normal corporate activities, such as corporate restructures, outside of the policy intent of this initiative.

Part II: ASC and ACDA tracking accounts

Whether the proposed transitional rule is appropriate

25. Given Inland Revenue's views on current law applying to ASC (and by extension, ACDA), the Law Society does not consider there is a compelling case for further administrative reporting.

26. However, should Option 1 be adopted, the transitional rule appears to be appropriate. We consider that ASC should be debited on a FIFO basis, such that is should be debited against FSC

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[1] This is somewhat accepted at paragraph 3.33 of the Discussion Document.
[2] As noted at paragraph 3.41 of the Discussion Document.
[3] This appears to be the intended reference.

prior to the formation of a tracking account, with any residual ASC not used then only being added to a tracking account. This method means taxpayers would have to calculate historical ASC amounts only when they seek to return an amount of ASC, and not immediately.

Whether the Commissioner should be able to reopen a return and on what basis

27. Consistent with other provisions across tax legislation, it would seem inappropriate for the Commissioner to reopen a return. The time bar should apply.

Whether the proposal strikes an appropriate balance between compliance costs and tax integrity

28. The Law Society is of the view that this proposal creates unnecessary compliance costs.

29. As noted in the Discussion Document and in OS 22/01,[4] taxpayers already bear the onus to evidentially substantiate the ASC and ACDA amounts of a business. Imposing an administrative barrier that would bar a proper claim of an ASC amount under Option 1, even where there is the evidence to prove such ASC amount, is undesirable. Further, the Law Society does not see any difference in substance between Option 2 and the current law. Option 2 is voluntary, just as the current law (as reflected in OS 22/01) is, in that a company can decide whether or not to keep records in relation to ASC (and ACDA) which would allow it to substantiate a claim in the future.

Whether the ASC and ACDA memorandum accounts should be reported in annual returns

30. We do not consider this should be required. The law currently imposes an evidential burden on taxpayers to prove they have the claimed ASC or ACDA. This would impose a further compliance burden.

Part III: Personal services income attribution

Do you agree with the proposed removal of the '80 percent one buyer' test? Why/Why not?

31. This appears to be appropriate.

Do you agree with the suggested decrease in the threshold for the '80 percent one natural person supplier' test, from 80 percent to 50 percent? Why/Why not? Can you foresee any problems arising from the suggested change?

32. The Law Society does not agree with this proposal, as it may have unintended consequences.

33. For example, consider a business with one principal and two others (a junior and a manager). To the extent the principal's charge out rate is higher than the others, they may derive 50% of the revenue for the firm. However, in this instance, there would be genuine reasons for a corporation to be used, namely, to be an employer for the other two staff members. To say the principal in this case is using a corporation to avoid tax in such a situation is incorrect. Further, this would add considerable complexity to the taxation of small businesses (or non-compliance for those who are not aware of such a rule).

Are the suggested thresholds for the substantial business assets test appropriate? Why/Why not?

34. They appear to be appropriate, particularly considering rising costs due to inflation.

35. The Law Society does not agree there is a need to remove the cost of vehicles. In particular, the reference to luxury vehicles – it is not clear what the definition of this is. A luxury vehicle is

[4] Available Subscribed Capital record keeping requirements.

subjective and would be difficult to define. In most cases, FBT should be returned on such vehicles if it is not otherwise exempted. It is not clear why these costs should be excluded.

Which of options one and two do you consider to be preferable? Is there another option that you think would be better then either of the thresholds suggested in this chapter?

36. Option 2 is preferred, as smaller legitimate businesses do not tend to have very large capital assets.

Do you consider the net income threshold should be increased from $70,000 per year to $180,000?

37. The Law Society considers the rule should be focused on those who are deliberately structuring to avoid the top marginal tax rate – being those who would otherwise be subject to the 39% tax rate, that are earning $180,000 and over.

38. Moreover, this would more likely capture those who are using a trust to hold the relevant company (i.e., those who seek to gain the tax advantage between the 33% trust tax rate and the 39% top marginal tax rate).

Further feedback

39. Thank you again for the opportunity to provide feedback on the Discussion Document. If you have any questions or wish to discuss the Law Society's feedback, please contact aimee.bryant@lawsociety.org.nz.

Nāku noa, nā

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