Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Tax system integrity and the alignment of tax rates

Date:	11 February 2010	**Priority:**	**High**
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Action sought

	Action Sought	Deadline
Minister of Finance	**Note** the issues raised in this report and **agree** to the recommendations. **Refer** report to Ministerial sub-group on tax.	17 February 2010 17 February 2010
Minister of Revenue	**Note** the issues raised in this report and **agree** to the recommendations. **Refer** report to Ministerial sub-group on tax.	17 February 2010 17 February 2010

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11 February 2010

Minister of Finance
Minister of Revenue

Tax system integrity and the alignment of tax rates

Executive summary

This report focuses on the issue of tax system integrity as raised in the Tax Working Group (TWG) final report. Integrity issues have arisen because the current non-alignment between the top personal tax rate and the trust and company tax rates allows taxpayers to arrange their affairs to shift personal income to lower-taxed entities. Further related issues have arisen because of the 30% cap on the maximum tax rate applied to PIEs.

There is a general consensus that the lack of integrity under the current system is unsustainable. The policy question is whether to address the problem through greater alignment of the relevant tax rates and/or through the introduction of special measures to ensure the integrity of the tax system.

The TWG has concluded:

> "The company, top personal and trust tax rates should be aligned to improve the system's integrity. If at any time this is no longer feasible due, for example, to global pressure causing the company rate to reduce, at the very least the trustee rate, top personal tax rate and top rate for portfolio investment entities (PIEs) and other widely held savings vehicles need to be aligned, accompanied by the introduction of suitable fiscal integrity measures."

The analysis in this report demonstrates that one key to addressing integrity concerns through changes to tax rates is the alignment of the top personal and trust tax rates. Company tax rates can remain somewhat lower than the top personal tax rate without raising significant integrity problems. For example, a 33/33/30 structure would substantially reduce the distortions and inequities of the current tax structure and is sustainable without the need for special integrity measures.

If a modest company tax cut were to be made, it is a matter of judgement at what difference between the top personal tax rate and company tax rate, any measures to protect the integrity of the tax system would be required. As the gap between the top personal and company tax rate increases, the need for special integrity measures increases. A number of possible integrity protection measures are outlined in this report. They include:

- extended attribution rules;
- an excess retention tax;
- extended deemed dividend rules;
- a special tax on investment income;
- enhanced dividend stripping rules; or,
- a capital gains tax.

These measures are complex and could not be developed in time for the Budget. In any event they would need to be the subject of extensive consultation.

Inland Revenue officials consider that, provided the trust and top personal tax rates are aligned at 33%, a cut in the company tax rate to 28% would not require special integrity protection measures. Inland Revenue officials consider that it would be unwise to commit to deeper rate cuts without having consulted on offsetting integrity protection measures. Consultation would also be desirable on the broader question of providing a deeper rate cut with special integrity measures, compared with a more aligned system without them.

The Treasury considers that while consulting on the two questions together may be helpful, the Government also has the option of announcing a company tax reduction in the Budget with a direction for integrity measures to be consulted on post-Budget, if the government feels it is important to signal the company tax change in the Budget. This means there may be a gap between the time the rate changes and when the integrity measures come into effect, but this would simply continue the situation that has been ongoing since 2000 for a little longer.

This report does not discuss the merits of reducing the company tax rate. As different elements of the Budget 2010 tax package come together, emerging information such as fiscal implications and the effect of base broadening on companies may help to inform Ministers. Officials will report on the merits of a company tax reduction in March. It is possible Australia may have announced the results of the Henry review or its preliminary intentions towards company taxation by then and this information may also be helpful.

The TWG also recommended that the cap on the portfolio investment entity (PIE) tax rate of 30% be removed, so that income would be taxed at the full marginal tax rate of the investor and that other collective investment vehicles be taxed at 33% (assuming a top personal tax rate of 33%). Taxation of PIEs raises a number of important integrity and efficiency concerns. Assessment of these will be contained in a later report.

Recommended action

We recommend (subject to final decisions on a tax package for Budget 2010) that you:

(a) **Agree** that the top personal tax rate and the tax rate applied to trustee income be aligned (the rate to be discussed with the accompanying report T2010/191, PAD2010/16).

Agreed/Not Agreed Agreed/Not Agreed

(b) **Note** that company tax rate can be somewhat lower than the top personal and trust tax rates without requiring special integrity protection measures. The difference is a matter of judgement.

Noted Noted

(c) **Agree** that a gap of three percentage points between the top personal and trust tax rates and the company tax rate, (a 33/33/30 rate system) is sustainable without further integrity measures being announced in this Budget.

Agreed/Not Agreed Agreed/Not Agreed

(d) **Note** that Inland Revenue considers that the company rate could be reduced to 28% before requiring new integrity protection measures, but that the Treasury considers that a cut below 30% may require integrity measures.

Noted Noted

(e) **Note** that Inland Revenue considers if company rate cuts that require special integrity protection measures are contemplated, that they be subject to a post-Budget consultation process examining the desirability of a deeper rate cut with special integrity measures, compared with a more aligned system without them.

Noted Noted

(f) **Note** that the Treasury considers that company rate cuts that require special integrity protection measures could be announced in the Budget with the measures to be developed through consultations after the Budget.

Noted Noted

(g) **Note** that a subsequent report will discuss the broader issues related to whether the company tax rate should be lowered.

Noted Noted

(h) **Note** that a subsequent report will discuss changes to the PIE tax rates.

Noted

Noted

Steve Mack
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Hon Bill English
Minister of Finance

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Background

1. The purpose of this report is to set out officials’ views on rate alignment between the top personal, trust and/or company rates, and whether special integrity protection measures are required if these rates are not aligned. Officials consider that the most important rates for alignment are the top personal tax rate and the trust tax rate. Pressures will also arise if the company tax rate and top personal tax rate are too far out of alignment. Concerns relating to the tax rate for PIEs are also raised. The report draws on the work and recommendations of the Tax Working Group (TWG).

2. Fundamental questions of tax and economic policy are raised by the issues discussed in this report. Some of these have been addressed in reports sent previously to Ministers, (T2009/2714 on “Where to from here on tax reform?” and PAD2010/6 on “Where to from here for tax reform? Rate alignment and the company tax rate” refer).

3. The desirability of more fundamental reforms is not considered in detail in this report. This is consistent with the Cabinet Paper “Options for Tax Reform in Budget 2010” (T2010/36 PAD2010/02) which concluded that work:

- would not consider “changing the fundamental structure of the current company tax framework”; and
- would be provided on changes to “personal, corporate, portfolio investment entity and trust tax rates”.

Major concerns to be addressed

4. The key policy question at issue, which will underpin much of the tax policy development work towards Budget 2010, is the relationship of the top personal tax rate to the company and trust tax rates. The rate of tax to be applied to PIEs will also need to be considered, depending upon changes to the other rates.

5. The TWG has stated that “The company, top personal and trust tax rates should be aligned to improve the system’s integrity. If at any time this is no longer feasible due, for example, to global pressure causing the company rate to reduce, at the very least the trustee rate, top personal tax rate and top rate for portfolio investment entities (PIEs) and other widely held savings vehicles need to be aligned, accompanied by the introduction of suitable fiscal integrity measures”.

6. Before 1999, the tax rates applying to companies, trusts and high-income individuals were the same. Alignment of these rates conveyed significant benefits. Income generally faced the same rate of tax regardless of the form in which it was earned, increasing economic efficiency and discouraging unproductive tax planning. Many complex features of other countries' less aligned tax systems were avoided.

7. However, subsequent deviations from that policy (increasing the top personal tax rate and lowering the company tax rate while leaving the trust rate unchanged) have led to the integrity problems highlighted in the report of the TWG, and have distorted economic behaviour. There is a consensus that the degree of non-alignment under the current system is unsustainable

8. The policy question is whether the problems can be addressed through changes that improve the alignment of tax rates, or would additional protection measures be needed that provide scope for a substantial cut in the company tax rate and greater non-alignment? This report recommends that the trust and personal tax rates be aligned, but notes that the company tax rate can remain somewhat lower without necessitating special integrity protection measures.

Links to other issues

9. This report concentrates on the limited tax rate changes that are required to deal with problems of non-alignment and on the potential integrity protection measures that would be needed if rates cannot be sufficiently aligned.[1] The accompanying paper on Personal Tax and the GST (T2010/PAD2010) addresses the broader issues of lowering personal tax rates

10. The tax treatment of PIEs, which was raised by the TWG in conjunction with the tax system integrity issues, is raised in this report, but will be discussed more fully in a subsequent report.

11. This report does not discuss the merits of reducing the company tax rate. As different elements of the Budget 2010 tax package come together, emerging information such as fiscal implications and the effect of base broadening on companies may help to inform Ministers. Officials will report on the merits of a company tax reduction in March. It is possible Australia may have announced the results of the Henry review or its preliminary intentions towards company taxation by then and this information may also be helpful.

12. This report does not address structures to avoid Working for Families (WFF) clawbacks. While there are some technical and policy concerns in common with non-alignment in the income tax system, WFF raises more fundamental elements of system design. These WFF issues will be dealt with in a separate report.

The problem of non-alignment

13. The problems caused in the current tax system due to the non-alignment of rates were extensively documented in the report of the TWG. There is overwhelming evidence that entities that face lower tax rates are being used to shelter personal income that would otherwise be taxed at the top personal income tax rate.

14. The current non-alignment of tax rates confers two types of benefits on taxpayers:

- *permanent benefits* are conveyed by the trust tax rate at 33%, and top PIE tax rate of 30%, compared with the 38% top personal income tax rate; and
- *deferral benefits* are conveyed by the company tax rate at 30%, as the difference between the company tax rate and the 38% top personal income tax rate is clawed back by the imputation system when dividends are paid out of the company's income.

[1] It does not discuss other issues such as the use of trusts to achieve income splitting benefits.

15. Permanent benefits lead to greater integrity problems since, unlike deferral benefits, they do not have to be paid back when funds are paid out to the owners of the entity.

16. Appendix 1 provides an example (previously reported in PAD2010/6), which shows the relative distortions arising from the different tax rates for an investment made through a low tax entity compared with an investment made directly by an individual.

17. Use of a trust structure conveys the greatest benefit, even for income which is distributed soon after it is earned. Income earned through a trust can be taxed at a final tax rate of 33%, while income earned through a company is eventually taxed at the personal tax rate of the shareholder. This has led to considerable levels of tax planning on the part of taxpayers, evidenced by the rapid growth in trustee income relative to beneficiary income. The distortion is even greater for a company owned through a trust.[2] Table 1 of Appendix 1 shows that after 20 years, the after-tax savings accumulation made through a trust and company structure is 14 percent higher than an investment held directly by an individual on the top personal tax rate.

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18. The benefit of making the investment through a company owned by an individual is considerably less than with a trust interposed as there is a deferral benefit only. The income is taxed at the 30% tax rate only as long as it is held in the company. Upon distribution, the imputation system ensures that the personal tax rate of 38% applies to the distributed earnings. Table 1 shows that the after-tax savings accumulation is increased by only 5% after 20 years and 12 percent after 40 years. Nevertheless, closely held companies have significantly increased their level of retained earnings since the introduction of the higher top personal tax rate. As the period of deferral increases, the benefit of the lower rate is increased. In some cases investment through a company can yield permanent benefits if the income is realised by selling the shares instead of receiving a dividend.

19. In many cases, individuals will wish to have immediate access to their income for consumption purposes. In that case, there is no benefit from earning investment income and personal service income through a company, since the lower company tax rate is immediately clawed back through imputation. However, trusts provide benefits even if the income is immediately distributed because the reduced final tax rate conveys permanent benefits. The after-tax income would be 8 percent higher.[3] The income is permanently sheltered from the higher 38% personal tax rate.

20. This suggests that the focus of tax rate changes to reduce non-alignment pressures should be on eliminating the permanent differences provided by the trust rate.

21. A significant distortion results from the use of a PIE to hold an investment where all income is subject to a maximum final tax rate of 30%.

How much rate alignment is necessary?

22. Under the National-ACT Confidence and Supply Agreement, “National and ACT noted that United Future favours reducing and aligning personal, trust and company taxes at a maximum rate

[2] Until 2007–08 there was no tax advantage in this structure relative to direct ownership of the investment through a trust as the company and trustee tax rates were aligned at 33 percent. It is too soon to see in the data how structuring of investments into companies owned by trusts will have resulted from the reduction in the company rate to 30%. However, anecdotal reports suggest that such restructuring is occurring.

[3] Eight percent is the ratio (1 - .33)/(1-.38); that is, the ratio of after-tax interest rates earned through a trust and directly.

of 30%. They agreed that such a tax structure is a desirable medium-term goal." Such a tax structure would achieve complete rate alignment and eliminate current integrity problems.

23. However, complete alignment at 30% may not be feasible as it would require reducing the top personal tax rate to 30%. Issues in lowering the personal tax rate are discussed more fully in the personal tax and GST Report (T2010/191, PAD2010/16 refers). However, complex integrity protection measures may not be needed if the difference between the company and personal/trust rate is not too large as the likely distortions and inequities may not be sufficient to justify their imposition.

24. A move to a 33/33/30 rate structure largely eliminates the problems currently associated with non-alignment. Importantly, the benefits from flowing income through entities are entirely eliminated for funds that are distributed rather than being accumulated. The key change underlying this result is aligning the trust and top personal tax rates. As a result of imputation, moderate differences between the top personal and company tax rates do not pose significant integrity problems.

25. Alignment of the trust and personal tax rates above 33% is possible. However, increasing the trust rate would increase taxes on businesses operating through trusts as well as trusts that have been used to avoid the top personal tax rate on investment and personal service income. They would be taxed at a higher rate than competing businesses operating through companies. Moreover, there would be little or no room for small reductions in the company tax rate without building in special integrity measures.

26. With a 33/33/30 structure, Table 2 in Appendix 1 shows that there would be no benefit for investments held directly by trusts. For investments held for 20 years in a company, the increase in the after-tax savings accumulation would be reduced to 3 percent compared with 14 percent (in Table 1) using a trust/company structure under current rates.

27. Our analysis suggests that a 3 percent gap between the top personal and trust rate and the company rate is sustainable. The rates are close enough that the company tax system essentially fulfils its role as a backstop to the personal income tax system.

28. The question then arises – at what difference in tax rates are the problems from non-alignment sufficient to warrant special integrity protection measures? As noted above, the critical tax rates to have aligned are the trust and top personal income tax rates. Divergences between the company rate and the personal rate of tax are mitigated by the imputation system, since benefits can be obtained only to the extent that funds are actually retained in the company. A divergence of three percentage points appears sustainable. As the divergence in tax rates increases beyond three percentage points, pressure will increase. It is a matter of judgement how much divergence is sustainable without requiring complex rules to buttress the personal income tax system.

29. Table 3 in Appendix 1 shows that lowering the company tax rate to 28% would have little impact on the after-tax savings accumulation for investments held in a company, unless earnings were retained for a very long time (7 percent increase after 40 years).

30. Divergences in tax rates can also cause pressures for individuals to try and extract retained earnings from companies without paying taxes on dividends (so-called "dividend stripping"). The amount of pressure depends upon the divergence of company and personal income tax rates. The benefits of dividend stripping when there is non-alignment can be seen by looking at the results for

PIEs reported in the Tables in Appendix 1. Dividend stripping effectively turns the company tax rate into a final tax similar to the way a PIE is taxed at the company rate.

31. The pressure for dividend stripping can be measured by the incremental tax rate on imputed dividends – that is the difference between the company tax rate and the tax rate of the shareholder. The incremental tax rate depends upon whether the dividends are paid directly to an individual or to a trust. Currently, the incremental tax rate on imputed dividends paid to an individual is 8% and 3% for trusts. Under a 33/33/30 system, the incremental tax rate would be 3% for both individuals and trusts so pressures for dividend stripping would be reduced. If the company tax rate were 28%, the incremental tax on dividends would be 5%, which is between the current rates for trusts and individuals. Further cuts in the company tax rate would increase the pressure.

32. New Zealand has rules to prevent dividend stripping. Moreover, the practice is complex and uncertain for taxpayers. On balance, and based on our analysis Inland Revenue Officials consider that a tax rate differential of up to five percentage points would be sustainable without additional integrity protection measures.

33. The Treasury notes that for many years the difference between the personal and company tax rates was six percentage points. This difference prompted significant behavioural change, with more income retained in closely held companies which did not

distribute dividends. Even if a five percentage-point difference does not alter the after-tax return enough to impose large economic efficiency costs, it does undermine the integrity of the tax system if it appears people can earn large amounts of income which can be taxed at lower levels than the personal income tax rate. The Treasury considers that some integrity measures may be needed even if the difference between the personal and company tax rates is five percentage points.

Potential integrity measures

34. A variety of special integrity protection measures are possible if the gap between personal and company tax rates is too large.

35. The definition of the integrity problem, and therefore the appropriate remedies, depends upon the motivation behind the company tax rate cuts. Possible integrity measures include:

- a limited anti-avoidance approach, which focuses on income routed through low tax-rate entities that could have been earned directly by individuals;
- an approach which attempts to tax all income earned by or on behalf of resident individuals at the personal tax rate, including all capital income (a full integration approach); and
- an approach which attempts to tax all capital income at a lower rate than all labour income (a "Nordic" approach).

36. The Nordic and full integration approaches would involve fundamental changes to the company tax system so they are not considered in this report. They would require substantial analysis before their merits could be assessed.

37. If the rate cuts are in response to international pressures, but the fundamental features of the present system are to be retained, the main concern would be to protect the personal income tax base from erosion due to shifting of personal non-business income to low-taxed entities. This anti-avoidance approach was the focus of the TWG report.

38. A variety of measures could be employed to deal with this concern. Measures can be applied as income is originally earned, over the period that funds are retained in an entity, or when funds are made available to shareholder/beneficiaries. Measures can eliminate final tax benefits or eliminate deferral advantages. A number of the measures can be seen as substitutes and others may be used in combination. The measures are outlined in greater detail in Appendix 2 and include:

- extending the attribution rules – attribution rules currently apply to tax-disguised employment income that is earned through companies to avoid the full personal tax rate. Consideration could be given to determine if these rules should be extended;
- an excess retention tax – an excess retention tax would subject accumulated savings in a lower-taxed entity to a special tax designed to eliminate the deferral benefit of retaining lower taxed funds in the entity rather than paying them out;
- extending the deemed dividend rules – currently, rules exist that deem dividends to have been paid in some circumstances if shareholders are considered to have benefited from funds that have been retained in the company. In a non-aligned system, this prevents shareholders from

avoiding the tax on the dividends if the retained earnings were paid out. These rules could be extended to cover some situations that would be targeted by an excess retention tax. For example, under a non-aligned system, it may be appropriate to consider all shareholder loans to be dividends. The extension would not deal with excess retentions of funds;

- a special tax on investment income – the rules would apply a special tax on investment income that is earned in a low-tax entity. The rate of the special tax would be set at the difference between the top personal tax rate and the entity tax rate. This rule, in combination with extended deemed dividend rules, could cover most situations that give rise to “excess” retentions;

- enhanced dividend stripping rules – divergences in tax rates can cause pressures for individuals to try and extract retained earnings from companies without paying taxes on dividends (so-called dividend “stripping”). The amount of pressure depends upon the degree of divergence between the company and personal tax rates; or

- a capital gains tax – the structural purpose of a capital gains tax would be to deter dividend stripping and prevent the deferral of dividend taxation through a sale of shares.

39. These measures would introduce considerable complexity into the tax system, especially for smaller businesses.

40. If more fundamental reforms to the tax system were contemplated, the analysis of integrity issues would change.

41. For example, a Nordic tax system would tax all income from capital at the company tax rate. Current arrangements, such as trusts, would no longer be necessary to avoid progressive personal tax rates on capital income. This means that the measures discussed above would not be needed. However, the Nordic system has had significant integrity problems in distinguishing capital income from high-taxed labour income. Another fundamental change would be to tax all income of domestically owned companies at their personal tax rates (a full integration model). This could raise competive concerns for domestically owned companies and would in turn be subject to its own integrity problems as taxpayers sought to avoid the higher tax rate.

42. Any tax system that seeks to tax different types of income or arrangements at different rates will have integrity problems in defining borders. Changing the system simply changes the circumstances in which the problems occur. The alignment of tax rates is the simplest way to avoid these problems.

43. The choice of integrity protection measures and the details of their implementation would require extensive consultation. Inland Revenue Officials consider it would be unwise to commit to deeper rate cuts without consulting on offsetting the impact of integrity measures. Consultation would also be desirable on the broader question of providing a deeper rate cut with special integrity measures compared with a more aligned system without them.

44. The Treasury considers that while consulting on the two questions together may be helpful, the government also has the option of announcing a company tax reduction in the Budget with a directive for integrity measures to be consulted on post-Budget, if the Government feels it is important to signal the company tax change in the Budget. This means there may be a gap between the time the rate changes and when the integrity measures come into effect, but this would simply continue the situation that has been ongoing since 2000 for a little longer.

Treatment of Portfolio Investment Entities (PIEs)

45. The TWG recommended that PIEs and other widely held savings vehicles be taxed at the tax rate of the investors. Assuming a 33/33/30 tax system, top income tax rate taxpayers would have an increase in tax rate over the current 30% maximum. This would remove artificial biases for people to use PIEs ahead of direct investments and to earn interest through PIE structures rather than normal bank accounts. From an efficiency and equity point of view, there is a strong argument in favour of removing the cap on the PIE tax.

46. However, the taxation of PIEs raises concerns of competitiveness with similar savings entities, such as unit trusts, that are not PIEs and may create other arbitrage opportunities or be sustainable only if other integrity protection measures are put in place. The taxation of PIEs will be the subject of a separate report later in the Budget decision-making process.

Conclusion

47. Key considerations are:

- The key recommended change, which would substantially reduce integrity pressures, would be to align the personal and trust tax rates.
- A gap can exist between the company tax rate and the other rates without the need for special integrity measures, but the degree of difference at which integrity protection measures will be needed is a matter of judgement.
- A gap of three percentage points (33/33/30) between rates is sustainable without further integrity measures.

- Inland Revenue officials consider that the company rate could be reduced to 28% before requiring new integrity protection measures but the Treasury considers that a cut in the company tax rate below 30% may require integrity measures.

- Integrity protection measures necessitated by a deeper company tax rate would require consultation after the Budget. Inland Revenue Officials consider such a company tax rate change should not be announced with the Budget, but be consulted on together with the integrity measures after the Budget. The Treasury considers the company tax rate cut could be announced with the Budget, while details of the integrity measures could be developed after the Budget.

- Whether to reduce the company tax rate below 30% raises other significant economic issues that are not addressed in this report. Officials will report on these issues at a later date.

- Implications for the PIE tax rate are complex and officials will also report on this later.

Appendix 1: Measurement of distortion

38/33/30 tax rate structure

The following Tables compare the increase in after-tax savings accumulation on an investment in a bond held directly by an individual taxpayer with bonds held in four circumstances:

- a trust holds the investment;
- a trust owns a company which holds the investment and retains the earnings until distributed to the trust as a dividend subject to imputation;
- a company holds the investment and retains the earnings until distributed as a dividend to an individual subject to imputation; and
- a PIE holds the investment, the earnings of which are taxed at the capped tax rate equal to the company tax rate.

In each case it is assumed that the person ultimately owning the investment is an individual on the top marginal tax rate.

Consider a $100 investment in a bond earning a six percent rate of interest. If this bond were held directly by an individual on the top personal income tax rate, they would earn $6 before tax, pay tax of 38% of $6 which is $2.28 for an after-tax savings accumulation of $3.72. If, on the other hand, they placed the bond in a trust and the income was taxed at the trust rate of 33%, they would pay $1.98 of tax for an after-tax savings accumulation of $4.02. The net increase of $.30 is 8% of $3.72 as reported in the first cell of Table 1.

Table 1

Percentage increase in after-tax savings accumulation 38/33/30 tax rate structure				
	Year			
	1	**10**	**20**	**40**
Trust	8%	10%	11%	16%
Company owned by trust	8%	10%	14%	21%
Company owned by individual	0%	2%	5%	12%
PIE	13%	15%	19%	26%

Line 1: Holding an investment in a trust applies the 33% trust rate as a final tax on the income from an investment.[4] A substantial benefit is obtained even for income which is distributed the year after it is earned. The benefit increases for retained earnings as the associated investment income faces the lower trust tax rate. This level of distortion has been sufficient to lead to considerable levels of tax planning on the part of taxpayers, evidenced by the rapid growth in trustee income relative to beneficiary income.

Line 2: The use of a company owned by a trust allows the investment income to be taxed at the 30% company tax rate until it is distributed, at which time it is effectively taxed at a final tax rate equal to the trust tax rate of 33%. Over time, a distortion results that is somewhat greater than an investment held directly by a trust.[5]

Line 3: The benefit of making the investment through a company owned by an individual is considerably less than in the previous two cases as the tax benefit is a deferral benefit only. The investment income is taxed at the 30% tax rate only as long as it is held in the company. Upon distribution, the imputation system ensures that the personal tax rate of 38% applies.

In many cases, individuals will wish to have immediate access to their income for consumption purposes. In that case, there is no benefit from earning investment income through a company, since the lower company tax rate is immediately clawed back through imputation. This result is reported in column 1 of Table 1. However, both of the trust structures provided benefits even if the income is immediately distributed because they provide reduced final tax rates that convey permanent benefits. The income is permanently sheltered from the higher 38% personal income tax rate.

This suggests that the focus of tax rate changes to reduce non-alignment pressures should be on eliminating the permanent differences provided by the trust rate.

Line 4: The Table also demonstrates that the greatest distortion results from the use of a PIE to hold the investment. All income is taxed at the 30% company tax rate and is a final tax rate. The appropriate taxation of PIEs raises a number of concerns that need to be discussed in the context of potential changes to other tax rates. It should be noted that in practice this distortion will be limited by the fact that PIEs can only be used to shelter certain forms of income, namely passive capital income.

A comparison of a company owned by an individual (line 3) and a PIE (line 4) illustrates the large difference between a deferral benefit (line 3) and a permanent benefit combined with a deferral benefit (line 4). A PIE faces a lower final tax rate regardless of the holding period of the investment. Accordingly there is an after-tax benefit (13 percent) even if the funds are

[4] Trusts may also convey income splitting advantages and can be of benefit if personal service income is earned through one.

[5] Until 2007–08 there was no tax advantage in this structure relative to direct ownership of the investment through a trust as the company and trustee tax rates were aligned at 33 percent. It is too soon to see in the data how structuring of investments into companies owned by trusts will have resulted from the reduction in the company rate to 30% . However anecdotal reports suggest that such restructuring is occurring.

immediately withdrawn. A company receives no benefit if the funds are withdrawn immediately. For the company, there is an increasing deferral benefit as the holding period increases. The PIE also enjoys this deferral benefit. Its combined permanent and deferral benefit for withdrawals in a later year is basically the sum of its immediate 13 percent benefit and the deferral benefit enjoyed by the company in that year. For example, in year 10 the combined PIE benefit is 15 percent; which is the 13 percent year one benefit plus the 2 percent deferral benefit for the company in year 10.[6]

33/33/30 tax rate structure

Table 2 shows the distortions that would arise if a tax rate structure of 33/33/30 were applied – that is, the trust rate was aligned with the top personal tax rate of 33% and the company tax rate remained at 30%. PIE rates of 33% and 30% are also shown.

Table 2

Percentage increase in after-tax savings accumulation 33/33/30 tax rate structure	**Year**			
	1	**10**	**20**	**40**
Trust	0%	0%	0%	0%
Company owned by trust	0%	1%	3%	4%
Company owned by individual	0%	1%	3%	4%
PIE @ 33%	0%	0%	0%	0%
PIE @ 30%	4%	5%	6%	9%

A move to a 33/33/30 tax rate structure largely eliminates the problems associated with non-alignment. Importantly, the benefits from flowing income through entities are entirely eliminated for funds that are distributed rather than being accumulated. If PIEs continue to be taxed at the 30% company tax rate, a benefit would remain for them, but would be greatly reduced, since the top personal tax rate would be reduced to 33%.

33/33/28 tax rate structure

Table 3 shows the increase in distortions that would arise from a further reduction of the company tax rate to 28%, while the top personal and trust tax rates are aligned at 33%.

[6] The rows are not strictly additive, so there is a small divergence over time.

Table 3

Percentage increase in after-tax savings accumulation 33/33/28 rate tax structure	Year			
	1	**10**	**20**	**40**
Trust	0%	0%	0%	0%
Company owned by trust	0%	1%	3%	7%
Company owned by individual	0%	1%	3%	7%
PIE @ 33%	0%	0%	0%	0%
PIE @ 30%	4%	5%	6%	9%
PIE @ 28%	7%	9%	11%	15%

Table 3 shows that provided the PIE rate is aligned with the company rate, distortions for investments held in companies remain reasonably small, except when held for very long holding periods. Reducing PIE rates along with the company rate would lead to substantial distortions in favour of such vehicles.

Divergences in tax rates can also cause pressures for individuals to try and extract retained earnings from companies without paying taxes on dividends, (so-called dividend “stripping”). Capital gains taxes are sometimes used to mitigate these pressures. The amount of pressure depends upon the divergence of company and personal tax rates. The pressure for dividend stripping that arises from non-alignment can be seen by looking at the results for PIEs reported in the previous Tables. Dividend stripping turns the company tax rate into a final tax, the same situation as a PIE taxed at the company rate. The Tables indicate that the incentive for dividend stripping would be reduced compared with the current system. At the level of rate divergence under discussion, our view is that current anti-dividend stripping rules in New Zealand appear to be adequate without the structural recourse of a capital gains tax.

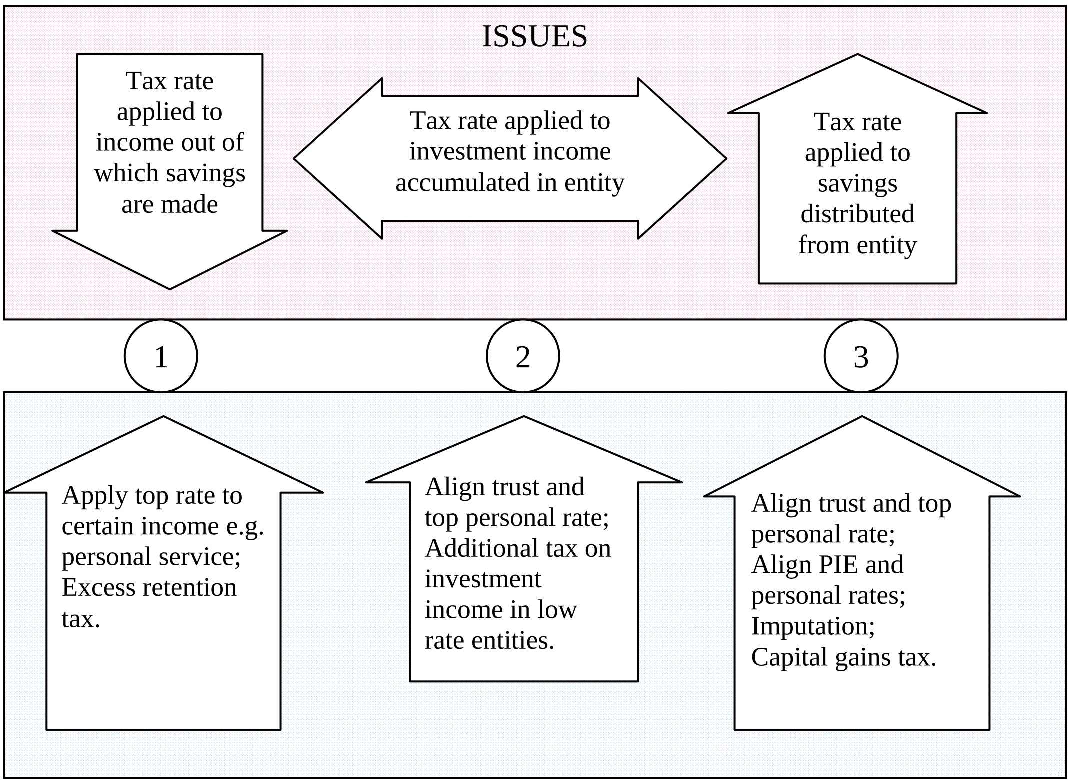
Appendix 2: Integrity measures

Non-alignment of tax rates can lead to variation of tax rates applying to personal income in a number of situations. These are:

- income from financial investments (interest-bearing securities or shares) held through different structures;
- personal service income earned through tax-preferred structures; and
- excess retentions, where income taxed at a preferential tax rate is retained in a company but invested in financial assets rather than business assets.

In a broader context, business income earned through a company instead of individually could also be considered part of an integrity problem.

The following chart (upper half) illustrates the timing of these issues over the income/savings cycle. Personal service income and excess retentions arise at stage 1, as income is taxed at the lower entity rate. All three situations can raise issues at stage 2 as investment income earned on the savings is taxed at the lower entity rate. At stage 3, income that is distributed may escape tax (dividend stripping, PIEs and unit trust) or may face a final tax rate that is less than the full personal income tax rate (trusts), or may be taxed with imputation credits that recapture the low company tax rate with deferral (dividends from companies).



Measures to deal with earnings that are accumulated from low-taxed income:

Extended attribution rules

Attribution rules currently apply to tax employment income that is earned through companies, so that funds retained will have paid the full personal tax rate. The attribution rules tax disguise employee compensation that seeks to receive the benefits of lower entity taxation. Consideration is needed to determine if these rules should be extended. In some countries, similar rules have been extended to apply to other activities that are considered to be related to personal service, such as professional income or incorporated consultants. Elimination of the final tax benefit currently available through the use of trusts combined with other measures to tax the investment income arising from funds retained in the entity may deal with concerns in this area.

Excess retention tax

An excess retentions tax would subject accumulated savings in a lower- taxed entity to a special tax designed to eliminate the deferral benefit of retaining low-taxed funds in a company, rather than paying them out as dividends.

A general excess retention tax could be used to force the payment of dividends (in cash or as taxable bonus issues) and enforce integration of the company and personal tax systems. It would have the effect of denying the benefit of any company rate reduction to resident-owned businesses. This would be a fundamental shift in the structure of company taxation.

The US has a somewhat more targeted form of excess retentions tax. The US Accumulated Earnings Tax is applied at a rate of 15% to retained earnings in companies that are “unreasonable”. Fifteen percent is the tax rate currently applied to dividends paid to individuals. The grounds for reasonable accumulations of Earnings and Profit include providing for the expansion of the business or replacement of a plant; the acquisition of the stock or assets of another business; the retirement of business debt; providing working capital; providing for necessary investments or loans to suppliers or customers; or providing for payment of reasonably anticipated litigation. Unreasonable accumulations are evidenced by loans to shareholders or using corporate funds for shareholders' personal benefit; loans having no reasonable relation to the business, especially if made to shareholders' relatives, friends or related corporations; investments that are unrelated to the corporation's business; or the retention of earnings to provide against unrealistic hazards. The tax is intended to buttress the US’s classical approach to dividend taxation and seeks to force companies to pay out dividends when there is not a business purpose for their retention. Interestingly, the tax in the US has a reasonably high threshold and applies to widely held companies as well as closely held ones.

In the context of a non-aligned system in New Zealand, such a tax targeted at closely held entities could be used to reduce the build-up of investment funds out of retained earnings. It could also be used to force the effective integration of personal service income through the payment of dividends. It would not deal directly with investments made from capital contributed to a company although it could force payment of the income earned with respect to the investments. While conceptually an excess retentions tax has some rationale, it would introduce considerable complexity in measuring the size of retentions and uncertainty in determining reasonableness. It could also interfere with business decisions on when to distribute profits. Some of the concerns that the tax addresses, such as loans to shareholders, can be dealt with through deemed dividend rules, personal service rules and taxes on investment income. Use of an excess retentions tax would reduce the structural role for taxing capital gains on shares.

Extended deemed dividend rules

Currently rules exist that deem dividends to have been paid in some circumstances where shareholders are considered to have benefited from funds that have been retained in the company. In a non-aligned system, this prevents shareholders from avoiding the tax on the dividends if the retained earnings were paid out. These rules could be extended to cover some of the situations that would be targeted by an excess retentions tax. For example, currently the low-interest benefit of loans made at concessional interest rates are deemed to be dividends. Under a non-aligned system, it may be appropriate to deem the principal of all shareholder loans to be dividends. The extension would not deal with excess retentions of funds that are invested in non-business assets, which could be the subject of a special tax on investment income.

Measures to deal with investment income that is accumulated in a lower-taxed entity:

Special tax on investment income

The rules would apply a special tax on investment income that is earned in a lower-tax entity. The rate of the special tax would be set at the difference between the top personal income tax rate and the entity tax rate. The tax would be applied to "passive" income. The tax could be refunded as dividends are paid to allow the normal rules of imputation to apply to dividends received by individuals. The major complexity arises from determining the borderline between passive and active investments. For example, interest can be earned on investments in a portfolio of bonds (passive) or could arise from loans undertaken by a company that is in the business of lending money (active). Rules are required to track dividends through chains of companies and after corporate restructurings.

An issue that will arise is whether investment income that is related to the business should be subject to the special tax. Examples include interest earned on working capital accounts or interest on funds set aside for business purposes such as acquisitions or reserves. Conceptually this raises the same concerns as determining "reasonable" under an excess retentions tax. On one hand, the special tax may be applied on interest earned while interest costs are deducted at the lower company tax rate. On the other hand, it would prevent interest being taxed at the lower company rate while interest expense is deducted at the personal tax rate. As the tax is a prepayment of tax at the personal tax rate, the issue is one of timing. Special tax paid would be refunded to the extent that dividends are paid in the year.

The tax would eliminate the deferral benefit from making financial investments out of contributed capital and would reduce the benefit of excess retentions.

Measures to deal with income that is subject to a low rate of final tax

Enhanced dividend stripping rules

Divergences in tax rates can also cause pressures for individuals to try to extract retained earnings from companies without paying taxes on dividends, (so-called dividend "stripping"). Under a dividend strip, the business assets and the cash are placed in separate companies and the cash company is sold to realise a tax-free capital gain. In this case, cash can be realised without selling the underlying business assets. Capital gains taxes are sometimes used to mitigate these pressures. The amount of pressure depends upon the divergence of company and personal tax rates. It would be appropriate to verify the effectiveness of dividend stripping rules that are intended to protect the integrity of dividend taxation. Other measures that reduce the potential build-up of low-taxed income in companies would reduce pressure in this area.

Capital gains tax

The structural purpose of a capital gains tax would be to deter dividend stripping and to prevent deferral of dividend taxation through a sale of shares. In the former case, New Zealand has rules that are designed to prevent dividend stripping – that is, rules designed to treat retained earnings distributed at liquidation as dividends. The pressure on these rules depends upon the amount of income that can benefit from deferral that would be taxed on normal distribution. If the gap between the top personal tax rate and the company tax rate is not too large, then the pressures on dividend stripping can be reduced through taxation of the investment income.

The second concern is that earnings could be retained in a business and then effectively realised through a sale of the shares of the business, resulting in a non-taxable capital gain. Unlike the case of a dividend "strip", in the latter situation there is a bona fide sale of the business. In that case, the continuity rules of the imputation system would provide some protection, by extinguishing any imputation credits. If the purchaser were subject to New Zealand tax on the eventual distribution of the retained earnings, a distribution of dividends before the sale would be the preferred option.