



**Tax policy report: The need for integrity-protection measures**

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<b>Date:</b>	26 April 2010	<b>Priority:</b>	Medium
<b>Security Level:</b>		<b>Report No:</b>	T2010/691 PAD2010/76

**Action sought**

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	<b>Action Sought</b>	<b>Deadline</b>
Minister of Finance	<b>Note</b> the issues raised in this report and <b>agree</b> to the recommendations.	Wednesday, 5 May 2010
Minister of Revenue	<b>Note</b> the issues raised in this report and <b>agree</b> to the recommendations.	Wednesday, 5 May 2010

**Contact for telephone discussion (if required)**

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26 April 2010

Minister of Finance  
Minister of Revenue

## **The need for integrity-protection measures**

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### **Executive summary**

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The purpose of this note is to report to Ministers on officials' conclusions on the issue of whether integrity protection measures may be needed as a consequence of the non-alignment of the company tax rate with the top personal and trust tax rates.

This analysis has been completed prior to the Budget. Officials have concluded that special integrity-protection measures need not be introduced as a consequence of the proposed non-alignment of the tax rates. Accordingly, this report is being provided to Ministers for their confirmation, so that they will be able to respond to questions regarding the Government's intentions in this area.

The Budget tax changes will reduce the gap between the top personal rate and the trust rate from five percentage points to nil (this gap generally provided a permanent tax advantage). The Budget tax changes are also reducing the gap between the top personal tax rate and the company rate from eight percentage points to five percentage points (this gap generally provided a deferral tax advantage). Both changes will reduce the costs of arbitrage and therefore the need for integrity-protection measures.

The report *Tax system integrity and the alignment of tax rates* presented analysis on the potential for permanently reducing or deferring personal taxes on investment income by making the investments through trusts and/or companies. The analysis demonstrated that tax reductions from such structures could be substantially eliminated by aligning the top personal tax rate with the trust tax rate at 33%. Officials have also investigated two other forms of tax planning using companies taxed at the lower 28% tax rate. These are:

- earning personal service income through companies; and
- retentions of business income.

Aligning the trust and top personal tax rates combined with imputation eliminates any benefit for personal service and business income that is distributed as it is earned. Retaining such income in a company offers two tax advantages to taxpayers. First, the income is taxed at 28% rather than 33% and so a larger amount of funds is available for saving. Secondly, the investment income on the retained funds is taxed at the lower company tax rate.

The analysis is similar to the investment income case. Once the top personal and trust rates are aligned, the benefit from retaining the funds in a company is a timing benefit only because of the imputation system. These benefits are not large for reasonable assumptions about retention periods. In some cases retentions may be held for a long period or income realised by selling shares for a non-taxable gain, making the benefit permanent.

To the extent arbitrage opportunities are available, these impose both efficiency costs and equity costs. However, anti-arbitrage rules may also impose their own efficiency costs and increase the complexity of the tax system. A judgement must be made whether the benefits of preventing arbitrage is justified by the costs of imposing the rules.

A further complexity is attempting to define when income earned through a lower tax-rate entity is consistent with policy and when it is not. For example, is earning capital income through a closely held company consistent with policy when a policy decision was made to ensure capital income earned through savings vehicles are taxed at a lower rate? There may be a more compelling case to look at integrity issues for labour income, however, this would raise complex issues and would require substantial analysis.

Therefore officials do not believe that immediate integrity-protection measures are necessary.

There are two broader policy issues linked to tax rates, which do not arise solely from differences between the company and top personal tax rates. These are:

- Income-splitting of personal service income by a top-rate taxpayer, where such income is earned through a trust or company, and then distributed to related individuals and so taxed at their lower marginal tax rates. The changes to the rate schedule have made a small reduction in the benefit from such arrangements, but substantial savings are still possible.
- Savings are currently taxed at a variety of rates. Savings held in PIEs and other widely held savings vehicles have a final capped tax rate of 28%. On the other hand, investments made directly in companies or financial instruments have a final tax rate which is the personal marginal tax rate of the investor. Accordingly, the form in which savings are held affects the tax rate applied to such income.

Both of these issues raise complex policy and technical concerns and should be considered in the light of other priorities in the tax policy work programme.

## **Recommended action**

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- (a) **Note** that Budget tax changes will align the top personal tax rate and the trustee rate, and will reduce the rate gap between these rates and the company tax rate, thereby reducing the costs of tax arbitrage.

Noted

Noted

- (b) **Note** that Treasury and Inland Revenue officials have further examined the need for special integrity measures and have concluded that there is no immediate need to introduce special integrity-protection measures with the proposed personal, trust and company tax rates of 33/33/28.

Noted

Noted

- (c) **Agree** that a gap of five percentage points between the top personal and trust tax rates and the company tax rate (a 33/33/28 rate system) does not require immediate integrity-protection measures being examined after Budget 2010.

Agreed/Not Agreed

Agreed/Not Agreed

- (d) **Note** that further analysis of integrity issues, such as arbitrage of labour income and income splitting, involves complex technical and policy analysis and should be prioritised among other projects in the tax policy work programme.

Noted

Noted

**Steve Mack**  
for Secretary to the Treasury

**Matt Benge**  
for Deputy Commissioner, Policy  
Inland Revenue

**Hon Bill English**  
Minister of Finance

**Hon Peter Dunne**  
Minister of Revenue

## Background

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1. The purpose of this note is to report to Ministers on officials' conclusions on the issue of whether integrity-protection measures may be needed as a consequence of the non-alignment of the company tax rate with the top personal and trust tax rates.
2. This issue has been discussed previously in the reports *Tax system integrity and the alignment of tax rates*, (PAD 2010/07, T2010/119 refers) and *The company tax rate*, (PAD2010/43, T2010/373 refers).
3. In the report, *The company tax rate*, Ministers agreed that if it were decided to reduce the company tax rate to 28%, officials should report back after Budget 2010 on possible integrity-protection measures.
4. This analysis has been completed prior to the Budget. Officials have concluded that immediate integrity-protection measures need not be introduced as a consequence of the proposed non-alignment of the personal and company tax rates.
5. This report is being provided to Ministers for their confirmation, so that they will be able to respond after the Budget to questions regarding the Government's intentions in this area.

## Analysis

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6. The report, *Tax system integrity and the alignment of tax rates*, presented analysis on the potential for permanently reducing or deferring personal taxes on investment income by making the investments through trusts and/or companies. Under existing tax rates, taxpayers can gain a permanent tax reduction by earning various forms of income through a trust. Income is subject to the trust rate of 33% rather than the top personal tax rate of 38%. The analysis demonstrated that tax reductions from such structures could be substantially eliminated by aligning the top personal tax rate with the trust tax rate at 33%.
7. The Budget tax changes will reduce the gap between the top personal rate and the trust rate from five percentage points to nil (this gap generally provided a permanent tax advantage). The Budget tax changes are also reducing the gap between the top personal tax rate and the company rate from eight percentage points to five percentage points (this gap generally provided a deferral tax advantage). Both changes will reduce the costs of arbitrage and therefore the need for integrity-protection measures.
8. Use of trusts will no longer confer a benefit from non-alignment. Using a company will continue to allow income to be taxed at the lower 28% company rate as long as it is retained in the company. The key point of the analysis is that the imputation system claws back any shortfall of tax at the company level, so that the benefits are timing deferral benefits only. Given the relative minor differences in tax rates, the deferral benefit is small, even for long periods of deferral, and so is unlikely to result in significant tax planning. However, in some cases the shareholder may realise the income by selling shares for a non-taxable gain, resulting in a permanent advantage.

9. Officials have subsequently investigated two other forms of tax planning using companies taxed at the lower 28% tax rate. These are:

- earning personal service income through companies; and
- excessive retentions of company income.

10. Aligning the trust and top personal tax rates combined with imputation eliminates any benefit for personal service income that is distributed as it is earned. However, earning personal service income through a company still offers two tax advantages to taxpayers to the extent that it can be retained in the company. First, the income is taxed at 28% rather than 33% and so a larger amount of funds is available for saving. Secondly, the investment income on the retained funds is taxed at the lower company tax rate.

11. A difficulty with attempting to apply integrity-protection measures to diversion of personal services income to a company is determining how much of the company income is from personal services. Some countries have attempted this in different ways – for example, Norway imputes income on assets on a deemed return basis and treats remaining income as if it were income from personal services. However, this is done in the context of a Nordic tax system where a division of income between capital and labour is done comprehensively regardless of the form in which it is earned and could not readily be incorporated into the New Zealand tax system without substantial analysis.

12. Excess retentions may be considered to occur when more funds from ordinary business activity are retained than are needed for the operations of the company. Retaining rather than distributing the funds provides similar benefits to those obtained by diverting personal service income.

13. The analysis in both cases is similar to the investment income case. Once the top personal and trust rates are aligned, the benefit from retaining the funds in a company is a timing benefit only because of the imputation system. Therefore special integrity-protection measures are less necessary.

14. 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 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 33/33/28 system, the incremental tax on dividends will be 5%, which is between the current rates for trusts and individuals. Therefore the issue of dividend stripping, while it remains, is less significant than it was before the Budget changes to the tax rates.

15. New Zealand has rules to prevent dividend stripping. Moreover, the practice is complex and uncertain for taxpayers. On balance, officials consider that there is no need for immediate additional integrity-protection measures.

## Related issues

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16. There are a number of broader policy issues linked to tax rates, which go beyond differences between the company and top personal tax rates. These are:

- Income-splitting of personal service income by a top rate taxpayer, where such income is earned through a trust or company, and then distributed to related individuals and so taxed at their lower marginal tax rates. The changes to the rate schedule have made a small reduction in the benefit from such arrangements, (from a maximum of \$10,450 to \$9,080 per annum, if the maximum income were split between an income-earning and non-income-earning spouse), but substantial savings are still possible.
- Savings are currently taxed at a variety of rates. Savings held in PIEs and other widely held savings vehicles have a final capped tax rate of 28%. On the other hand, investments made directly in companies or financial instruments have a final tax rate of the personal marginal tax rate of the investor. Accordingly, the form in which savings are held affects the tax rate applied to such income.
- Currently, the attribution rules apply the personal tax rates to employment income earned through trusts and companies. The proposed changes to tax rates reduce the need for these rules and questions may arise over whether they will be retained. No changes are proposed at this time. The attribution rules raise issues that are linked to the previous issues and should be considered at the same time.

17. These issues raise complex policy and technical concerns and should be considered in the light of other priorities in the tax policy work programme.

**Appendix 1: Measurement of distortion**

18. The report, *Tax system integrity and the alignment of tax rates*, provided information on the magnitude of the pressure to divert personal income to lower tax entities when tax rates are not aligned. The report examined a bond which was held through a variety of entities. This appendix extends this analysis to two other situations of interest. The following tables compare the increase in after-tax savings accumulation for three types of income:

- interest on a bond;
- employment income; and
- business income;

when the income is earned and retained for different periods of time in a company or a trust. The comparison is made with income earned directly by an individual at the top personal tax rate. The Tables compare the effects of the current 38/33/30 structure with the proposed 33/33/28 structure.

19. 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 six percent of \$3.72 as reported in the first cell of Table 1.

**Table 1**

<b>Investment income</b>				
	<b>Year</b>			
	<b>1</b>	<b>10</b>	<b>20</b>	<b>40</b>
<b>38/33/30</b>				
<b>Trust</b>	8%	10%	11%	16%
<b>Company</b>	0%	2%	5%	12%
<b>33/33/28</b>				
<b>Trust</b>	0%	0%	0%	0%
<b>Company</b>	0%	1%	3%	7%

20. Table 1 shows there is no benefit under a 33/33/28 rate structure from investing through a trust or if the income is distributed as it is earned. There is some benefit from tax deferral for income retained in a company, but that benefit is small, even for substantial retention periods. It is substantially reduced compared with the current rate structure.



21. Table 2 examines two other cases. The first occurs when personal service income is earned through a trust or a company rather than being earned directly by the individual. The second occurs when business income is retained in a company and invested in non-business investment assets rather than being distributed to shareholders and invested by them. The interest income is therefore taxed at the lower company tax rate rather than the top personal tax rate.

**Table 2**

<b>Employment and business income</b>				
	<b>Year</b>			
	<b>1</b>	<b>10</b>	<b>20</b>	<b>40</b>
<b>38/33/30</b>				
<b>Trust</b>	8%	11%	14%	21%
<b>Company</b>	0%	4%	9%	20%
<b>33/33/28</b>				
<b>Trust</b>	0%	0%	0%	0%
<b>Company</b>	0%	3%	6%	12%

22. The results are similar to those reported in Table 1 for investment income. Alignment of the top personal tax rate and the trust tax rate eliminates trusts as a source of tax reduction. As a result of the imputation system, the benefits of using company structures are also much reduced. Critically, all benefit is eliminated for funds that are passed directly through a company. Thus there is no benefit for the bulk of income that is spent as it is earned. The benefits are slightly higher in these later cases than with pure investment income since the taxpayer is able to invest a higher amount of savings, since the original income is tax at the lower company tax rate of 28% rather than 33%. The extra savings are clawed back by imputation and so confer a timing benefit rather than a permanent tax benefit.