

# Regulatory Impact Statement: Dividend integrity and personal services income attribution

## Coversheet

<b>Purpose of Document</b>	
Decision sought:	Analysis produced for the purpose of informing the release of a discussion document.
Advising agency:	Inland Revenue
Proposing Ministers:	Minister of Finance Minister of Revenue
Date finalised:	25 February 2022
<b>Problem Definition</b>	
<p>The introduction of the 39% top personal income tax rate has increased the incentives for high income individuals to restructure their affairs so that they earn income through lower tax rate entities. s 6(c)</p>	
<b>Executive Summary</b>	
<p>The introduction of the 39% personal income tax rate for income over \$180,000 has increased the difference between the company and top PIE tax rates (28%) and the top personal tax rate from five percentage points to 11 percentage points. There is now also a difference between the trustee tax rate (33%) and the top personal tax rate. This increase in or creation of differences in rates increases the incentive for people to structure their affairs so that their income is at least partly earned through lower tax rate entities.</p> <p>An increase in structuring may impact on Government revenue, social capital and the integrity of the tax system and equity in the tax system. s 6(c).</p>	
<p>There are a range of options that could be used to help address these concerns. The discussion document considers options for dealing with company issues. Other options for dealing with other issues such as trust taxation have been deferred and are discussed further in the limitations section below.</p>	

The company measures considered in the discussion document include dividend integrity issues, Available Subscribed Capital (ASC) and net capital gains reporting and possible expansion of the personal services attribution rule. Another area of company taxation that was initially considered is the area of shareholder loans. This has been deferred but is also discussed below.

### **Limitations and Constraints on Analysis**

The Government has ruled out aligning the top personal income tax rate with the company and trustee tax rates or introducing a capital gains tax. Instead, the Government has directed officials to work on integrity measures that focus on mechanisms that divert the income of a taxpayer on the 33% or 39% rate through channels that allow it to be taxed at a lower rate.

Inland Revenue will be receiving more specific information from trustees for the 2021–22 and later income years under provisions in the recently enacted amendments to the personal income tax rate legislation. This additional information could help inform in more detail how trusts are used and what measures could be considered to prevent under-taxation from the use of trusts. For this reason, the work on trust integrity measures has been deferred until the additional information has been received. It has also been publicly stated that officials would consider any potential changes to the taxation of trusts based on the new information.

The use of shareholder loans is another complicated aspect of the work on integrity measures and, to date, it has not been possible to complete this work due to limited resources. Consequently, this has been deferred.

Data for the 2021–22 income year (being the income year that the new 39% rate came into effect) is incomplete, so officials have had to rely on pre-2021 data and small amounts of current year data. Behavioural trends are however well-established from historic data, including from the period that the former top personal income tax rate of 39% was in effect (between 2000 and 2009).

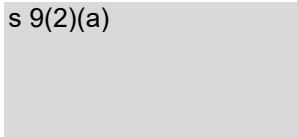
Consultation on the proposed integrity measures is incomplete, as the discussion document proposed for release will form the key part of the consultation process.

Further data analysis will occur as the consultation process takes place.

### **Responsible Manager**

Paul Fulton  
Acting Policy Lead  
Policy and Regulatory Stewardship  
Inland Revenue

s 9(2)(a)



25 February 2022

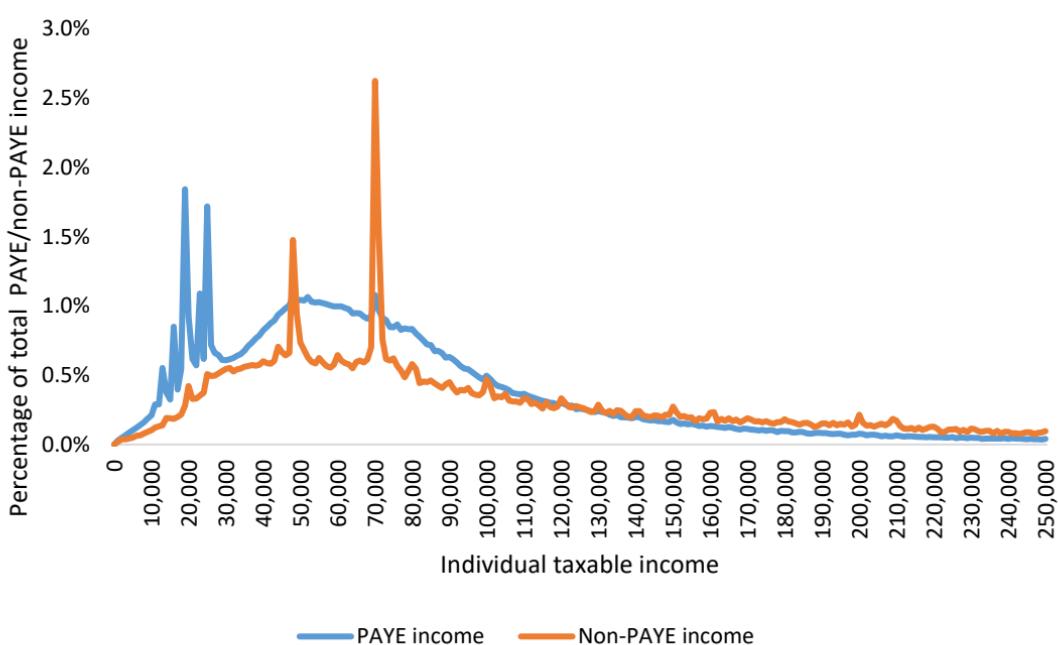
<b>Quality Assurance</b>	
Reviewing Agency:	Inland Revenue
Assessment and Comment:	<p>The Quality Assurance reviewer from Inland Revenue has reviewed the Dividend integrity and personal services income attribution interim regulatory impact statement (RIS) prepared by Inland Revenue and considers that the information and analysis summarised in the RIS partially meets the quality assurance criteria. This is because the impacts on the affected taxpayers are currently unknown. Consultation on the proposals may help to inform the likely magnitude of the impacts and to refine the design of the proposals to minimise or reduce compliance costs. Inland Revenue will report back to Cabinet with a final RIS with further information on these impacts when final policy decisions are sought following public consultation.</p>

## Section 1: Diagnosing the policy problem

### What is the context behind the policy problem and how is the status quo expected to develop?

1. The Government enacted legislation to put in place a 39% personal tax rate on income above \$180,000 from 1 April 2021. This rate is significantly higher than the trustee tax rate (33%), the top PIE tax rate (28%) and the company tax rate (28%). While there was already a difference between the company and the top PIE rate and the top personal tax rate, this difference has increased from five percentage points to 11 percentage points. Prior to the change the top personal tax rate and the trustee tax rate were the same at 33%.
2. Even before the introduction of the 39% rate there were concerns arising from the differences between entity and personal tax rates. The bunching of self-employed people at the pre-2021 tax thresholds in Figure 1 suggests that structures were being used by taxpayers to avoid the former top personal rate of 33% and at this time the differences between the rates was significantly less.

**Figure 1: Taxable income distribution: PAYE and non-PAYE income (2018)**



Source: The Treasury's analysis of Inland Revenue administrative data.

3. The greater difference between the rates provides a greater incentive for people to structure their affairs so that their personal income is derived through lower tax rate entities. It also incentivises the transfer of income from entities such as companies in ways that do not result in personal income. Returns treated as capital are therefore preferred over dividends which are taxable as personal income.
4. Initial information for the current year is indicating some potentially interesting behaviours among the high income population. This is indicative information only and officials note that until all of the 2022 personal income tax returns are filed, Inland Revenue does not have the full picture of what changes customers have made to their remuneration structure. Officials also note that many businesses will have experienced

a reduction in overall income as a result of COVID-19 which may have a correlation with decreased owners' remuneration.

5. Inland Revenue has prepared initial analysis based on filed personal income tax returns (about 60% of the analysed population have filed), PAYE and investment income returns focused on customers who meet the following criteria:
  - Individuals whose declared income exceeded \$170,000 in both the 2019 and 2020 tax years; and
  - Individuals whose declared income, or income taxed at source exceeded \$180,000 in the 2021 year.
6. Customers **without** an ownership/control association with their employer:

	<b>Actual</b>	<b>Estimated</b>	<b>% change</b>
	<b>31 March 2021</b>	<b>31 March 2022</b>	
<b>Total employment income</b>	\$16,979,000,000	\$14,724,000,000	13% ↓
<b># of employment income recipients</b>	74,500	68,000	9% ↓
<b>Average employment income</b>	\$228,000	\$217,000	5% ↓

7. Customers **with** an ownership/control relationship with the employing entity:

	<b>Actual</b>	<b>Estimated</b>	<b>% change</b>
	<b>31 March 2021</b>	<b>31 March 2022</b>	
<b>Total employment income</b>	\$4,287,000,000	\$3,656,000,000	15% ↓
<b># of employment income recipients</b>	22,500	22,000	2% ↓
<b>Average employment income</b>	\$191,000	\$166,000	13% ↓

8. In an ordinary arm-length situation officials wouldn't expect an employee's income to decrease (except to the extent, in the current environment, that they are impacted by COVID-19). Based on the data above, high-income employees who are not associated with their employer have shown a 5% decrease in their average income. In comparison those employees who own/control their employer (that is, are a director or shareholder of the employer entity) have shown a 13% decrease in their average incomes that takes them to an average income below the \$180,000 threshold for the 39% personal tax rate.
9. Since November 2020 the target population have formed 10,633 new companies, 2,630 new trusts and 362 new partnerships. This is a 28% increase in the volume of new entities established by this population from the prior 12 month period. This combined with the estimated movements in income is causing concern that structures may be being used to reduce incomes below \$180,000.
10. s 6(c)

11. There are also some specific rules such as the personal services attribution rules that are intended to prevent people from diverting their personal income to lower tax rate entities. The personal services attribution rule is very narrowly framed and effectively only captures situations that are similar to direct employment with one buyer and one seller of services that the seller personally performs.
12. Without further action to support the integrity of the 39% personal tax rate it is expected that structuring would increase. The Government has attempted to reduce this risk by announcing that further integrity measures would be adopted if structuring was observed.

### **What is the policy problem or opportunity?**

13. Structuring activity resulting in people avoiding the 39% rate would cause the revenue generated by the rate change to be less than forecast impacting on the Government's ability to fund its activities. This has non-monetary impacts as well, such as eroding public confidence in the tax system and voluntary compliance. This would have a negative impact on tax integrity.
14. Where people structure their affairs so that they derive income through lower tax rate entities, rather than as personal income, this can also have a negative impact on the effectiveness of a range of other regimes such as Child Support, Working for Families tax credits and student loans/allowances. All of these regimes rely on the accuracy of the measurement of personal income.
15. s 6(c) 

16. Measures that successfully support the application of the 39% personal tax rate would support the integrity of the tax system as a whole as well as protect Government revenue and help to ensure the accuracy of personal income calculations.
17. As noted in the context section, the Government has previously warned that changes will be made to prevent structuring to avoid the 39% rate if evidence of such structuring is observed. Failing to make such changes would be likely to encourage further people considering structuring activities.

### **What objectives are sought in relation to the policy problem?**

18. There are three objectives sought in relation to the issues discussed:
  - **An integrity objective:** The Government is seeking to minimise opportunities for structuring activity with the purpose of avoiding the top personal tax rate of 39% or the second-highest personal tax rate of 33%.
  - **A revenue objective:** The ability to continue to face the challenges of COVID-19 and to support the New Zealand economy as it recovers from the pandemic will depend on a strong tax base. The Government is seeking to ensure the continuity of tax revenue streams by ensuring that massive revenue leakage is not occurring as a result of the current tax settings.
  - **A distributional objective:** The motivation for the recent introduction of the 39% top personal income tax rate was to raise extra revenue in a way that is progressive and does not increase the tax burden on low to middle income

earners. The Government intends that any integrity measures to support the 39% rate will be broadly consistent with this objective and with current tax policy settings, including the current rates of income tax.

19. The analysis will focus on how well each proposed option meets these **integrity**, **revenue** and **distributional** objectives by applying tax policy criteria which provide an analytical framework to assess strengths and weaknesses of individual options.

## Section 2: Deciding upon an option to address the policy problem

### What criteria will be used to compare options to the status quo?

20. **Efficiency:** The options should minimise the excess burden of economic efficiency cost of the tax system (that is, the cost of raising tax from New Zealanders which is over and above the tax revenue actually raised). This ensures that tax is doing as little as possible to distort labour supply, savings and investment, and entity decisions.
21. **Equity:** The options should ensure taxpayers with similar levels of income pay similar levels of tax (horizontal equity) and that taxpayers on higher incomes pay higher levels of the income tax in a way that reflects the Government's objectives of increasing the progressivity of the tax system (vertical equity).
22. **Complexity:** The options should minimise the introduction of complexity as much as possible. Generally, complexity should be minimised so that tax laws are easy to comply with and difficult not to. This encourages voluntary compliance over time, which benefits both the tax take as well as paying tax at rates intended by the Government.
23. **Integrity:** The options should maintain protection against taxpayers using other vehicles taxed at lower rates to avoid the 33% or 39% rate. Integrity in the tax system ensures that taxpayers cannot access methods or vehicles to avoid paying tax at rates applicable to them given their economic circumstances. This also leads to greater collection of tax revenues, as well as high income individuals paying the correct amount of tax without being able to successfully engage in avoidance behaviour. This improves the fairness of the tax system and is an important factor that supports voluntary compliance.
24. **Revenue raised:** The options should be effective at preventing revenue leakage arising from avoidance behaviour. Using this criterion is important to ensure the primary function of tax collection is achieved by the policy settings.
25. In the context of integrity measures to support the 39% rate, any measures that would meet the equity, integrity and revenue criteria are likely to come at the cost of reduced efficiency and increased complexity. This is mostly because such measures tend to be complex by their nature, and therefore are likely to increase taxpayers' compliance costs and, potentially, Inland Revenue's administration costs. The integrity and equity criteria have the highest weighting, with both the efficiency and complexity criteria having a lower priority or weighting.

### What scope will options be considered within?

26. The scope of policy options under consideration in this Impact Statement include dividend integrity and income attribution measures relating to the use of entities (and, in particular, closely-held companies) by relatively high income individuals.
27. The Government has ruled out aligning the top personal income tax rate with the company and trustee tax rates or introducing a capital gains tax. Instead, the Government has directed officials to work on integrity measures that focus on mechanisms that divert the income of a taxpayer on the 33% or 39% rate through channels that allow it to be taxed at a lower rate.
28. Inland Revenue will be receiving more specific information from trustees for the 2021–22 and later income years under provisions in the recently enacted amendments

to the personal income tax rate legislation. This additional information could help inform in more detail how trusts are used and what measures could be considered to prevent under-taxation from the use of trusts. For this reason, the work on trust integrity measures has been deferred until the additional information has been received. It has also been publicly stated that officials would consider any potential changes to the taxation of trusts based on the new information. Consequently, this Impact Statement does not consider these issues.

29. Relevant experience from other countries has been considered in defining the scope of the policy options for consideration. In particular, officials have studied the experience of other tax administrations with their rules governing sales of shares and shareholder loans.

## **What options are being considered?**

### **Option One – Status quo**

30. This option involves continuing with the current rules and tax compliance activity. The problem definition section explains the issues this creates and how they are likely to worsen over time. It fails to achieve the Government's integrity and revenue objectives. It retains the distributional and progressivity outcomes resulting from the current tax settings.

### **Option Two – Increased compliance activity**

31. Non-regulatory options to address the problems identified include increased enforcement activity by Inland Revenue, including more guidance to taxpayers and education on what specific activities or behaviours Inland Revenue considers objectionable and will take action against where these are identified. However, these options have significant limitations, namely that they are heavily reliant on the general anti-avoidance rule and on increased operational resourcing for Inland Revenue.
32. Reliance on the general anti-avoidance rule requires that the arrangement in question has an evident purpose or effect of tax avoidance. The facts of each situation must be looked at individually and it is not always obvious whether arrangements have such a purpose or effect. It can therefore be time consuming and resource intensive to prove there is an evident purpose or effect of tax avoidance. s 6(c)

Inland Revenue's general experience has been that, when there is a specific and identifiable situation where avoidance is a concern, it is usually better to have a specific rule that addresses the concern than it is to rely on the general anti-avoidance rule.

33. Further, the policy concerns in relation to share sales and derivation of personal services income through companies are not restricted to arrangements with a purpose of tax avoidance. Therefore, to more effectively address the integrity and distributional issues and provide taxpayers and Inland Revenue with certainty, it is preferable to have specific integrity measures rather than rely on the general anti-avoidance rule.

### Option Three – Package of integrity measures

34. This option comprises dividend integrity measures and changes to the personal services attribution rule, including:
- Treating any sale of shares in a company by the controlling shareholder as giving rise to a dividend to the shareholder, to the extent that the company (and its subsidiaries) has retained earnings.
  - Requiring companies to maintain a record of their available subscribed capital and net capital gains, so that these amounts can be more easily and accurately calculated. This would in turn enable accurate calculation of the dividend amount arising on a share cancellation or liquidation of the company.
  - Broadening the scope of the personal services attribution rule, so that instead of narrowly targeting taxpayers who are similar to employees, the rule captures a wider array of scenarios where an individual may use an entity associated with them (such as a company or a trust) as a conduit for selling their personal services to one or more customers. The rule currently applies in narrowly defined circumstances when income from “personal services” performed by an individual is earned through an associated entity. The rule attributes the income from personal services to the individual who performs the services, thus ensuring that the income is taxed at the individual’s marginal rate of personal income tax, rather than at the company rate of 28% or the trustee rate of 33%.
35. This option would be an improvement over the status quo in relation to each of the integrity, revenue and distributional objectives. However, it would increase taxpayers’ compliance costs and the complexity of the tax rules, and key private sector stakeholders (including the affected taxpayers and their advisors) are likely to not support this option.
36. The impacts of this option will be direct. No obvious flow-on effects have been identified to date, although consultation may help to identify any flow-on effects.
37. The effects of the share sales proposal will, on an individual taxpayer basis, largely be one-off, as the proposal will only apply when a taxpayer who is a controlling shareholder of a closely-held company sells shares in the company, which for most of these taxpayers will not be a frequent occurrence.
38. The frequency or recurrence of the impacts of the proposal to require taxpayers to keep records of available subscribed capital and net capital gains will depend on the final design of the proposal. In any case, taxpayers already need to account for the transactions that give rise to available subscribed capital and available capital distribution movements in their financial records. Any requirements to report these movements or to retain records of them is likely to be minor going forwards although some work might need to be done to establish the starting position. If taxpayers are required to file memorandum accounts of available subscribed capital and net capital gain amounts with Inland Revenue on an annual basis (similar to the existing requirement to file imputation credit accounts annually), then the effects of the proposal will have a small recurring element although this may be able to be automated by accounting software providers. If taxpayers are merely required to maintain a record of these amounts and retain any documentation that supports the entries in the accounts, then the impact for most taxpayers would be minimal.

39. The effects of the personal services attribution proposals will be recurring or ongoing over time, in that the affected taxpayers will have to attribute income earned through an associated entity from personal services and will need to include the attributed income in their personal income tax returns each year. In addition, more taxpayers would need to consider whether they were impacted by the rules if they were widened as proposed.
40. The magnitude of the impacts is at this stage unknown, although officials would expect the impacts for most affected taxpayers to be relatively minor. The threshold rules would be specific so it should be relatively easy to determine, based on the facts, whether the rules apply. Despite this a number of taxpayers would be likely to seek tax advice if they were concerned that they may be caught by the rules. Consultation on the proposals may help to inform the likely magnitude of the impacts and to refine the design of the proposals to minimise or reduce compliance costs.

## How do the options compare to the status quo/counterfactual?

	Option One –Status Quo	Option Two – Increased compliance activity	Option Three – Package of integrity measures
<b>Efficiency</b>	0	Reduces distortions created by differing tax rates but increases resourcing requirements for Inland Revenue -	Reduces distortions created by differing tax rates but increases compliance costs -
<b>Equity</b>	0	Improves vertical and horizontal equity +	Improves vertical and horizontal equity +
<b>Complexity</b>	0	0	Integrity measures are complex -
<b>Integrity</b>	0	Increased disincentives for avoidance +	Reduced structuring incentives for avoidance +
<b>Revenue raised</b>	0	Raises some revenue +	Raises some revenue +
<b>Overall assessment</b>	0	<b>+ but concerns over ability to implement due to increased specialist resourcing requirements</b>	<b>+</b>

### Key

- ++** much better than doing nothing/the status quo/counterfactual
- +** better than doing nothing/the status quo/counterfactual
- 0 about the same as doing nothing/the status quo/counterfactual
- worse than doing nothing/the status quo/counterfactual
- much worse than doing nothing/the status quo/counterfactual

## What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

41. Inland Revenue considers introducing a package of integrity measures (option three) to be a more desirable option than the status quo or option two. Option three is an improvement over the status quo in relation to the integrity, equity and revenue criteria, but is worse than the status quo on the efficiency and complexity criteria which have a lower weighting than the other three criteria. Option three is also preferred to option two as there are concerns over the practical ability to implement option two. Inland Revenue concludes that option three is better than the status quo because it better meets the Government's integrity, distributional and revenue objectives.

## What are the marginal costs and benefits of the option?

Affected groups	Comment	Impact	Evidence Certainty
<b>Additional costs of the preferred option compared to taking no action</b>			
Regulated groups <i>Self-employed persons and shareholders of closely held companies earning more than \$70,000 per annum for the personal services attribution and share sales measures. All companies for the available subscribed capital and available capital distribution amount measures.</i>	Increased complexity and compliance costs (some ongoing, some one-off) Higher tax liabilities (ongoing)	Low	Low
Regulators <i>Inland Revenue</i>	Some increase in administration costs associated with updating guidance and educating taxpayers (largely one-off, some ongoing costs in educating taxpayers and enforcing the rules)	Low	High
Others (eg, wider govt, consumers, etc.)	N/A	N/A	N/A
<b>Total monetised costs</b>			
<b>Non-monetised costs</b>		Low	
<b>Additional benefits of the preferred option compared to taking no action</b>			
Regulated groups	N/A	N/A	N/A
Regulators	Some reduction in administration costs associated with taxpayers keeping better records of available subscribed capital and net capital gains (ongoing)	Low	Medium

	Improved information flows about taxpayer's income and more accurate calculations of social policy entitlements and obligations		
Others	Increased Crown tax revenues (ongoing) Improved horizontal and vertical equity and perceptions of the integrity and fairness of the tax system (ongoing)	Medium	Low
<b>Total monetised benefits</b>			
<b>Non-monetised benefits</b>		<i>Medium</i>	

42. The costs and benefits are dependent on the policy proposals that are proceeded with following the consultation process. The basic assessment of costs and benefits above is based on the suggested proposals in the discussion document and will be updated following consultation.
43. The costs in relation to determining the application of the share sale changes and the personal services attribution rule changes proposed are treated as being low on the basis that specific rules and thresholds would apply. The clarity of the rules is important to reduce costs that would be incurred determining whether the rules apply.
44. The assessment of costs in relation to the available subscribed capital and the available capital distribution amount reporting proposals as being low is based on the understanding that companies will be accounting for the transactions already and are required to determine whether any gains or losses are capital or revenue already.
45. MBIE has expressed concern that the proposed changes could put off investors from investing in start-up companies. Inland Revenue officials consider that this risk is limited due to the proposed share sale changes being limited to controlling interests. Start-up companies also tend to make losses initially so there is less likelihood that there will be much of any early sale price that represents retained earnings.

## Section 3: Delivering an option

### How will the new arrangements be implemented?

46. If the Government decides to proceed with the proposed integrity measures following public consultation, the new rules are currently planned to be introduced in an omnibus tax bill in the second half of 2022, with application from the 2023–24 income year.
47. Inland Revenue will be responsible for the implementation and ongoing administration of the new rules. As public consultation on the proposals has not yet taken place and, at the time of writing this Impact Statement, Cabinet has not made a decision (in-principle or otherwise) to proceed with the proposals, comprehensive consideration of how the policy will be implemented has not yet occurred. However, Inland Revenue will provide information to increase awareness and support taxpayers to comply with the new rules. This will include producing a relevant *Tax Information Bulletin* item and updating guidance on Inland Revenue’s website. Overall, Inland Revenue expects that relatively minor alterations to systems and operations will be needed.

### How will the new arrangements be monitored, evaluated, and reviewed?

48. **Monitoring:** The revenue impact of the proposed integrity measures will be estimated through tax collected by Inland Revenue. In practice, it will be difficult to evaluate the effect that the proposed measures have on minimising top-rate avoidance. However, investigations that rely on the proposed integrity measures will indicate how effective those measures are from a legal perspective. Inland Revenue also records data on its customer compliance and customer support activities, so existing systems are already in place to record new administrative impacts arising from this proposal.
49. **Review:** Inland Revenue regularly reviews tax settings on an ongoing basis and provides advice and updates to the Government accordingly. Policy officials maintain strong communication channels with stakeholders in the tax advisory community, including through the generic tax policy process, and these stakeholders will be able to correspond with officials about the operation of the new rules at any time. If problems emerge, they will be dealt with either operationally, or by way of legislative amendment if agreed by Parliament.