# The Treasury

## Budget 2023 Tax Initiatives Information Release

## July 2023

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POLICY AND REGULATOY STEWARDSHIP

## Tax policy report: Minimum tax – Further design decisions

| **Date:** | 2 February 2023 | **Priority:** | High |
|---|---|---|---|
| **Security level:** | | **Report number:** | IR2023/009<br>T2023/74 |

## Action sought

| | **Action sought** | **Deadline** |
|---|---|---|
| Minister of Finance | **Agree** to recommendations<br>**Discuss** the contents of this report | 7 February 2023 |
| Minister of Revenue | **Agree** to recommendations<br>**Discuss** the contents of this report | 7 February 2023 |

## Contact for telephone discussion (if required)

| **Name** | **Position** | **Telephone** |
|---|---|---|
| Stephen Bond | Manager, The Treasury | [39] |
| Phil Whittington | Chief Economist, Inland Revenue | [35] |

2 February 2023

Minister of Finance
Minister of Revenue

## Tax Policy Report: Minimum tax – Further design decisions

### Executive summary

#### Purpose

1. The purpose of this report is to provide you with advice on the further design decisions required to implement a minimum tax.

#### Context and background

2. Following initial advice in December, you directed officials to proceed with policy work on a minimum tax and agreed to a series of preliminary design decisions. Under this tax, a person with high wealth pays tax on the greater amount of either their 'deemed income' (calculated as a percentage of their net wealth) or the taxable income they have under existing income tax rules.

3. In this report, we seek your agreement to further design decisions in order to meet the intended Budget timeline. These are related to the treatment of trusts and gifts to adult children, foreign assets, the annual tax calculation, and valuation.

#### Treatment of trusts and asset splitting risks

4. Following the 13 December report, you expressed two particular concerns about the proposals for assets held on trust. These are:

   4.1 How clear would the distinction be between trusts whose assets were subject to the minimum tax and those that were not, and

   4.2 Whether the proposals were sufficient to prevent inappropriate asset splitting amongst family members. We understand that part of this concern was around gifts to adult children who were below the threshold. You also asked whether it might make sense to attribute trust assets to beneficiaries in more situations than we proposed.

5. We have also been giving further thought to our 13 December recommendations. In this report we respond to your concerns and expand on these recommendations.

#### *Definition of trusts where the trustee is subject to the minimum tax*

6. In the December report, you agreed that charitable trusts, community trusts, Māori authorities, or other similar trusts not for the benefit of specific persons or classes of persons would not be subject to the minimum tax. Following this report, you indicated that you wanted further advice on how these trusts were going to be excluded and whether the definition of excluded trusts was clear.

7. Tax law does not currently distinguish between trusts in the way that we propose, so a new category of trusts will need to be defined. We propose two options and

are confident that one or both of these will be adequate.  We do not seek approval to a recommendation at this stage.

### *Gifts to adult children*

8. Your office has also indicated that you are interested in further advice on what can be done to reduce the risk of taxpayers gifting their assets to other people not within the standard definition of a family, but with whom they may be able to share the use of assets with in some way (most significantly, gifting to their adult children) as a way to avoid the wealth threshold for the minimum tax.

9. There are some possible options to reduce the risk of assets being gifted as a way to avoid the minimum tax. These include:

   9.1 grouping the assets of parents and all (not only minor) children;

   9.2 treating gifted assets as still being owned by the donor; or

   9.3 imposing a tax on gifts as a way to dissuade gifts being made in the first place.

10. Officials would not recommend progressing with any of these options, as they all have significant flaws that would make them either difficult to work in practice, or result in other negative outcomes that would likely outweigh the benefit. We note that gifts which are not genuine can be disregarded, and that even for genuine gifts, the circumstances in which this would be a viable strategy for avoiding the minimum tax are very limited as they rely on family wealth close to the threshold, and on there being sufficient adult children with sufficiently low family assets of their own who are willing to enter into such an arragement.

### *Attribution of assets of a discretionary trust with no living settlor*

11. We recommended in our December report that where the principal settlor of a discretionary trust is alive, the assets of the trust are combined with the assets of the settlor.

12. Where the principal settlor is deceased there are two possible approaches:

   12.1 The trust acts as if the principal settlor were still alive and applies the minimum tax if the assets of all trusts with the same principal settlor, plus the assets of the deceased settlor's spouse and minor children are above the exemption threshold

   12.2 The trust attributes the assets to the beneficiaries of the trust.

13. Officials consider that the second approach would not always reflect the reality of who controlled the trust, and might be seen as too far reaching. For this reason, we recommend the first approach.

## Annual tax calculation

14. Appendix 1 of this report outlines the basic annual calculations that would be required for a person who is subject to the minimum tax. This includes proposals for how to calculate the deemed return amount and taxable capital income.

15. Adjustments will need to be made for significant interests in New Zealand companies[1]. Income taxed at the company level that is not distributed as a dividend

[1] Both listed and unlisted companies

will not be part of a shareholder's taxable capital income. As a result, they may have to pay additional tax on deemed income from their ownership of the company. Unless special provisions are made, the minimum tax has the potential to discourage the use of companies.

16. We propose that shareholders with at least a 10% interest in a company be given the option to be treated as if they had additional taxable income from capital of their share of the company's undistributed taxable income.

17. Adjustments will also need to be made for businesses which distribute both capital and labour income, such as professional service companies and trades people. We generally treat distributions from companies as capital income earned from the shareholder's investment in shares. However, in some cases, part of the return could be a return on the shareholder/owner's labour.

18. If we did not make an adjustment for this, it is possible the minimum deemed income would not attribute income to some low-return assets as it should. While it is difficult to have a definitive way of apportioning capital and labour components, the minimum tax regime includes a presumptive deemed return on capital value. Therefore, we are proposing that for a business that is controlled by a taxpayer that performs substantial services in the business, the income of the business that is treated as capital income is limited to the deemed return plus a margin from the assets of the same business.

19. Another issue that will need to be addressed in the annual deemed minimum tax calculation is the issue where taxable capital income fluctuates because of timing differences where taxable income will arise later in the period of the investment, e.g., in start-up businesses. In order to address overtaxation due to timing differences, we are proposing a general carryforward adjustment.

## Valuation

20. Valuation will be a challenging, and likely compliance-heavy, aspect of a minimum tax. As a general approach, we do not recommend valuation methods be rigidly prescribed in legislation and instead delegate power to the Commissioner of Inland Revenue to prescribe and/or approve specific valuation methods. This allows for flexibility and time for stakeholder consultation during the legislative process.

21. Broadly speaking, we recommend using open market value as the basis for valuing assets. This aims to determine the asset price that buyers and sellers would be willing to purchase and sell for on the open market.

22. Based on international practice, we have outlined our initial thoughts on how the open market value of different classes of assets, such as private companies and commercial property, could be assessed. However, consultation will be required to understand the feasibility of these approaches in the New Zealand context.

23. We also intend to explore options to reduce the compliance costs imposed by valuing assets, such as reducing the frequency of valuations and applying an annual growth rate to asset values.

## Foreign assets

24. You previously agreed that the minimum tax would apply to all assets with certain exclusions. Officials have subsequently considered the treatment of foreign assets further, in particular the treatment of 'controlled foreign companies' (CFC)[2].

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[2] Controlled foreign companies are foreign companies that are owned and controlled by New Zealand residents.

25. CFCs currently have an income tax exemption for 'active income' that is not paid to their shareholders as a dividend. This results in a tax deferral benefit until any dividend is paid.

26. The deemed minimum tax will remove this benefit. Despite this, officials still recommend that shares in active CFCs be included in the regime. This approach is consistent with the objective of imposing a minimum tax on low taxable-return assets. However, this could discourage investment in overseas businesses. Imposing this tax may also encourage investors to migrate since they do not have to be in New Zealand to operate the foreign business.

**Next steps**

27. We intend to discuss these design decisions with you on 7 February and will report you again on 13 February with further decisions.

**Recommended action**

We recommend that you:

a) **discuss** this report with officials at the Joint Ministers meeting on 7 February 2023.

*Treatment of trusts and asset splitting risks*

b) **note** that we will explore options to distinguish between trusts that are subject to the minimum tax and those that are not;

Noted Noted

c) **agree** that the only attribution of assets owned by a discretionary trust with no living principal settlor should be to the spouse of the deceased settlor at the time of the settlor's death and any minor children, where those persons are also beneficiaries of the trust;

Agreed/Not agreed Agreed/Not agreed

d) **note** that officials have considered options for addressing the ability of some taxpayers to make gifts as a way to avoid the entry threshold of the minimum tax, but recommend against these options as there are significant problems with all of them.

Noted Noted

e) **agree** that where a person makes a gift to their adult children, no measures should be taken to address the possibility that such gifts mean assets are taken out of the minimum tax due to the children having assets under the threshold;

Agreed/Not agreed Agreed/Not agreed

*Annual tax calculation*

f) **agree** that in order to recognise that a shareholder of a company bears the cost of tax on the company, if a shareholder owns at least 10% of a New Zealand company, the taxpayer may be treated as if it had additional taxable income from capital of its share of the company's undistributed taxable income;

Agreed/Not agreed Agreed/Not agreed

g) **agree** that an election to use this treatment is binding on the taxpayer with respect to shares in the same company in future years unless the regime stops applying to the taxpayer;

Agreed/Not agreed Agreed/Not agreed

h) **agree** that in order to account for owning assets that generate both capital and labour income:
- If a taxpayer together with other persons own a controlling interest in a business in which the taxpayer and those other persons perform substantial services towards the business earning income;
- The income of the business that is treated as capital income is limited to the deemed return plus a margin from the assets of the same business

Agreed/Not agreed Agreed/Not agreed

i) **note** that officials will work on further details to implement the above.

Noted Noted

*Valuation*

j) **agree** to use open market value as the basis for valuing assets for the purposes of a minimum tax;

Agreed/Not agreed Agreed/Not agreed

k) **agree** that the legislation will delegate power to the Commissioner of Inland Revenue to prescribe and/or approve valuation methods for specific assets;

Agreed/Not agreed Agreed/Not agreed

l) **direct** officials to develop a consultation paper seeking views on proposed valuation methods for release shortly after the legislation is introduced.

Direct/Do not direct Direct/Do not direct

*Foreign assets*

m) **agree** that foreign assets of an individual or trust may be subject to the regime;

Noted Noted

n) **agree** that shares of a controlled foreign company (CFC) may be subject to the regime, thereby overriding the active business income exemption of a CFC for a New Zealand shareholder.

Noted Noted

*Next steps*

o) **note** that officials will report to you on remaining design decisions on 13 February.

Noted Noted

**Stephen Bond**
Manager
The Treasury

**Phil Whittington**
Chief Economist
Inland Revenue

**Hon Grant Robertson**
Minister of Finance
/ /2023

**Hon David Parker**
Minister of Revenue
/ /2023

# Minimum tax – Further design decisions

## Purpose

28. The purpose of this report is to provide you with advice on further design decisions required to implement a minimum tax.

## Context and background

29. On 13 December 2022, we provided you with an initial assessment of a minimum tax for inclusion in Budget 2023 (T2022/2703; IR2022/516 refers). Under this regime, a person with high wealth would pay tax on the greater amount of either their 'deemed income' (calculated as a percentage of their net wealth) or the taxable income they have under existing income tax rules.

30. At the 15 December Joint Ministers meeting, you directed officials to proceed with policy work on a minimum tax and agreed to a series of preliminary design decisions.

31. We are seeking your agreement to further design decisions required to meet the intended Budget timeline. The decisions in this report, which we intend to discuss with you on 7 February, are as follows:

    31.1 How trusts and gifts to adult children will be treated under the regime,

    31.2 The treatment of foreign assets (including controlled foreign companies),

    31.3 The method for calculating annual tax (including adjusting for company interests, distributing capital and labour income, and carry-forward adjustments), and

    31.4 How assets will be valued under the regime.

32. We will provide you with further advice on remaining design decisions in the coming weeks. Table 1 outlines our proposed timeframe. Under this timeframe, the substantive decisions on a minimum tax could be made by Budget Ministers 4 on 20 March, which would allow it to be integrated into the BEFU forecasts, and final decisions with any fiscal impacts will be made before the Budget moratorium.

**Table 1. Proposed decision-making timeframe for a minimum tax**

| Date | Action |
|---|---|
| 13 February | Officials will report to you:<br>• Seeking your decision on remaining design issues (including treatment of farms and start-ups, deferral mechanisms, and the application date)<br>• Providing our initial indicative revenue estimates |
| 2 March | Officials will report to you seeking final decisions on any outstanding issues for a minimum tax |
| 10 March | Officials will report to you with:<br>• Our final views on the policy and revenue impacts of a minimum tax<br>• Any legal risks with a minimum tax, including potential risks under Te Tiriti o te Waitangi |
| 17 March | A draft of the Cabinet Paper and officials Regulatory Impact Assessment |
| 5 April | Cabinet paper lodged |
| 11 April | Cabinet decision |

## Treatment of trusts and asset splitting risks

33. Our 13 December Report made the following recommendations on assets held on trust.

    33.1 The minimum tax would apply (subject to meeting the threshold in the ways described below) to assets held by most trusts, with the exception of charitable trusts, community trusts, Māori Authorities or similar trusts;

    33.2 Assets held on a fixed trust (where the identity of the beneficiary and their share of the assets is specified from the outset) would be combined with the relevant beneficiary's assets to determine the application of the threshold to both the beneficiary and that portion of the trust assets;

    33.3 Assets held on a discretionary trust with a living principal settlor would be combined with the living principal settlor(s)' assets to determine the application of the threshold to both the principal settlor(s) and the trust assets;

    33.4 Assets held on a discretionary trust with no living principal settlor would be combined with the assets of other discretionary trusts with the same principal settlor, and (on that trust-combined basis) subject to the threshold on a stand-alone basis.

34. You expressed two particular concerns about these proposals:

    34.1 How clear would the distinction be between trusts whose assets were subject to the minimum tax and those that were not, and

    34.2 Whether it might make sense to attribute trust assets to beneficiaries in more situations than we proposed.

**Definition of trusts where the trustee is subject to the minimum tax**

35. In the December report, you agreed that charitable trusts, community trusts, Māori authorities, or other similar trusts not for the benefit of specific persons or classes of persons would not be subject to the minimum tax.

36. Following this report, you indicated that you wanted further advice on how these trusts were going to be excluded and whether the definition of excluded trusts was clear.

37. The trusts whose assets are intended to be directly subject to the minimum tax (that is, where the trustee is the person who has to calculate and pay any tax) are commonly referred to as 'family trusts'. Tax law does not currently distinguish between these trusts and the excluded trusts. Therefore, a new category of trusts will need to be defined in order to make this exemption workable. We propose two options below and are confident that one or both of these will be adequate. Officials are not seeking a decision on which option to progress at this time, as this is a design detail that can be considered again as the overall proposal is developed.

***There are two options for how to distinguish in-scope trusts from excluded trusts***

38. We see two options for describing trusts subject to the regime. The first is to define the kind of trust intended to be covered, and then provide for short list of exclusions, largely for the avoidance of doubt. The definition could for example refer to a trust where the trust assets are held substantially for the benefit of the principal settlor, all or any of their relatives, or other natural persons who the settlor wishes to benefit (a similar definition already exists, in section EX 46(6) of the Income Tax Act 2007). There could then be a short list of exclusions, e.g., for a:

    38.1 unit trust,

    38.2 Portfolio Investment Entity (PIE),

    38.3 charitable trust, and

    38.4 Māori interest in communally owned assets managed via a trust structure, such as a Māori Authority.

39. The other approach would be to start by making all trusts subject to the minimum tax on their assets, and then have a longer list of exclusions. The exclusions we have identified to date, in addition to those referred to immediately above, are:

    39.1 Community trusts recognised under the Community Trusts Act 1999,

    39.2 Energy consumer trusts such as Entrust, in which no beneficiary has a significant economic interest,

    39.3 Group Investment Funds and non-PIE superannuation funds. These have no discretionary element, and so the tax can simply be applied to the person with an interest in the trust based on the value of their interest,

    39.4 Community Housing Trusts under the Community Housing Management Act 1992,

    39.5 Trusts regulated by the Sale and Supply of Alcohol Act 2012, and

    39.6 Public authorities

    39.7 Securitisation trusts.

40. We are confident that one or both of these approaches will be adequate, and do not seek approval to a recommendation at this stage. This issue can be considered further as the proposal is developed.

### *Despite the exemption, the minimum tax will still indirectly impact on some of these trusts*

41. It is important to note that despite the proposed exemptions, the minimum tax will still apply indirectly to many trust assets. That is, in situations where the trust itself is not subject to the tax but owners of beneficial interests in the trust are so subject. This would include assets held by unit trusts (taxed as companies), portfolio investment entities (PIEs), and other investment vehicles.

## Attribution of assets of a discretionary trust

42. As set out in the December report, we proposed that assets of a discretionary trust with a living settlor would be attributed to the settlor for the purpose of applying the threshold to the settlor's own assets, and vice versa. This seems appropriate as until a distribution is made or an irrevocable interest in the assets is assigned to particular beneficiaries, the settlor has not fully transferred the power or benefits of ownership to any other person.

43. In your feedback following the December report, you indicated that you wanted further advice on options for attributing trustee assets in discretionary trusts to beneficiaries rather than the settlor.

### *Officials consider attributing assets to a living settlor to be preferable to attributing them to beneficiaries*

44. We do not think it would make sense to attribute the assets of a discretionary trust with a living settlor to any of the beneficiaries for the purpose of determining their threshold. Discretionary beneficiaries have no more than a right to be considered for a distribution. In a general law sense, this is reflected in the fact that none of them is treated as a beneficial owner of the trust assets. The trustees are of course required to act in accordance with the terms of the trust, but this will usually give them a very wide discretion. They will in practice be strongly guided by the wishes of the settlor who has put the assets into the trust. The settlor will often retain the ability to discharge trustees and appoint new ones.

### *Who to attribute assets to when there is no living settlor is less clear*

45. Who to attribute assets to in the case where there is no living principal settlor is less clear. One option in that case would be to continue to apply the threshold as if the settlor were still alive but had no assets. In that case:

    45.1 In applying the threshold to the trust's own assets, they should be combined with the assets of other trusts with the same deceased principal settlor (this was the limit of our proposal in the 13 December report).

    45.2 In applying the threshold to the assets owned by the deceased principal settlor's spouse and minor children, the trust assets would also be taken into account, that is, the same attribution that would apply before the settlor died (this is wider than proposed in the 13 December report).

46. There is also an argument that the deceased's adult children could be presumed to have a sufficient say in the application of the discretionary trust assets that the trust assets should also be added to their own personal assets in determining if they exceed the entry threshold for the minimum tax.

47. It would be difficult to do this on the basis of actual control of the trust as this would vary from trust to trust, and would not be evident on the face of the trust deed. As a rule of thumb, it could be on the basis of a pro rata allocation to each of the spouse and adult children. For example, if the principal settlor were survived by a spouse, 3 adult children and 2 minor children, then 25% of the trust assets each could be attributed to the adult children when they apply the threshold to their own assets. 100% of these assets could also continue to be attributed to the surviving spouse and minor beneficiaries, just as it was when the settlor was living. This would be the most robust of the three possibilities in terms of countering asset splitting. However, it would not always reflect the reality of who controlled the trust, and might be seen as too far reaching.

48. For these reasons, officials recommend the option referred to in paragraph 45.

## Possible privacy issue

49. Officials have identified that there is a possible privacy issue raised by any proposal for the assets of a settlor or beneficiary to be taken into account in determining the application of the tax to the assets of a trust, or part of them[3]. This would inevitably require the beneficiary to inform the trustee whether the beneficiary's separate assets were sufficiently valuable to take the trust's assets (or part of them) over the threshold. The beneficiary's position might also be able to be inferred by another beneficiary who has access to the trust accounts, since those accounts would reflect any minimum tax required to be paid.

50. This issue would not prevent the proposal from going ahead, but might be something that does need to be managed and possibly addressed in the design of the tax. We can see two possible ways to avoid the need for disclosure by a beneficiary.

    50.1 Make attribution one way only, so that a beneficiary's assets are not attributed to a trust in determining the application of the threshold to the trust assets. This might justify a lower threshold for trust assets.

    50.2 Impose on the beneficiary instead of the trustee the obligation (if any) to pay the minimum tax on the trust's assets, either on a mandatory basis, or on an elective basis. This is a more complex solution than the first.

## Gifts to adult children to take advantage of the threshold

51. While there will be strong rules to minimise the ability for taxpayers to use trusts to avoid the deemed minimum tax, these rules do not touch on the ability for a taxpayer to simply gift an asset. You have expressed concern about wealthy families' ability to avoid the wealth threshold for entering the deemed minimum tax regime or reduce the value of their assets that are subject to the tax by making gifts to other people not within the standard definition of a family, but with whom they may be able to share the use of assets with in some way (principally, adult children). Such gifts would reduce the person's own assets subject to the minimum tax, and might do so without putting the adult child's assets over the threshold.

52. It is important to note that if the gift is not really a gift but merely a transfer of legal title with the donor retaining beneficial ownership, then the asset would be treated as belonging to the donor as a tax matter, just like any other asset held by

[3] There does not seem to be a privacy issue raised by the proposal for trust assets to be aggregated with the assets of beneficiaries to determine whether the beneficiaries have to apply the minimum tax with respect to their own assets. Nor do we think there is a material issue with respect to the proposal that in the case of a discretionary trust with a living settlor, the settlor's assets be taken into account in determining the application of the tax to the trust assets.

a custodian or bare trustee. Anti-avoidance rules could also apply, for example if the donor had an option to buy the asset back for a bargain price.

### *Gifting assets to adult children as a way to avoid the minimum tax will only be a workable strategy in limited circumstances*

53. The extent to which a taxpayer can use gifts as a way to avoid the entry threshold for the minimum tax will heavily depend on their individual circumstances. The number of children a person has, the amount of the threshold, and the value of each child's other assets will determine if this would be an effective strategy. A taxpayer would not be able to effectively gift large amount of assets unless they had either a large number of adult children, or if their children had a low level of personal assets prior to the gifting.

54. For very wealthy people these factors are likely to substantially limit the proportion of their wealth that can be removed from the minimum tax base in this way.

### *Officials have identified three possible ways to reduce the risk of taxpayers gifting assets as a way to avoid the minimum tax*

*Aggregating assets of parents and adult children when applying the entry threshold*

55. One way to counter such gifts is to aggregate the assets of parents and all (not only minor) children. This would require sharing of private financial information between taxpayers in a way that would be a very different approach from anything else in New Zealand tax law and social policy law that we are aware of. This option could also be considered unfair to parents and children who have completely separate financial activities and no significant gifts have been made, and only become subject to the minimum tax due to their separate financial affairs being combined.

*Treat gifted assets as still owned by the donor*

56. Another way to deal with it would be to treat the gifted asset as still owned by the donor. Such a system would be practically and conceptually difficult. In particular, it would be difficult to attribute to a parent the income (and tax paid on that income) of assets held by adult children as a result of a gift by the parent, especially where the gifted assets have been intermingled with the other assets of the adult child.

57. There are also significant issues that would need to be considered if this approach was progressed, such as how to deal with changes in the value of assets that are acquired with gifted cash, and how to deal with the situation where a gift of cash is used to meet expenses rather than acquiring an asset. These issues (and likely other issues that have not been identified) would be difficult to resolve, particularly in the time available to design this tax.

*Gift duty*

58. A third way to deal with the issue is to impose a gift duty, to act as a broad deterrent to all gifts. However, it would be difficult to calibrate the value of a gift duty so that it imposed an appropriate cost on a transfer. The benefit of a transfer will depend on a number of factors, such as:

    58.1 Whether the donee is below the threshold when the gift is received,

58.2 If the donee is below the threshold, the length of time that the donee remains below the threshold, and

58.3 The taxable income produced by the asset.

59. A gift duty that applied only to assets gifted to adult children would also appear somewhat anomalous, and would likely be open to being planned around.

### *Officials are of the view that all of these options have significant flaws*

60. Officials consider that all of the possible solutions identified have significant flaws and that the best approach at this time is to not develop any specific rules to prevent the use of gifting to adult children as a way to reduce the value of assets subject to the minimum tax. In our view, asset splitting of this kind is an unavoidable element of the proposal and can best be taken into account as a factor in the setting of the threshold itself.

61. If it becomes apparent after the deemed minimum tax comes into force that gifting assets is a strategy used by a large number of taxpayers to plan around the tax, officials can revisit the question of whether a specific rule is needed.

## Adjustment for businesses distributing capital and labour income

62. In Appendix 1, we provide a detailed description of what we are proposing for the annual tax calculation mechanics. We also outline the adjustments required for significant interests in New Zealand companies, as well as carryforward adjustments.

63. In the December report, we recommended that an adjustment be made for income from businesses owned by the taxpayer, and for which the taxpayer also provides substantial services to the business earning income, to separate capital income from labour income. We indicated we would provide additional information on this.

64. We generally treat distributions from companies as capital income, as they are a return on the shareholder's investment in shares. However, in some cases, part of the return could be a return on the shareholder/owner's labour. Examples are incorporated professional service companies, such as for consultants, accountants, and lawyers; and for trades people, such as plumbers and electricians, where the owner also performs services. Unless we made an adjustment for this, it is possible the minimum deemed income would not attribute income to some low-return assets as it should.

**Baseline example: legal practice**

A lawyer has two assets: shares in a private practice law firm ($200,000) and equity in a bach ($200,000).

The lawyer is the only person practicing and pays herself no salary.

All other employees were paid a salary and have no shareholding.

The legal practice makes a taxable income of $500,000, all of which is paid to the lawyer as a dividend.

Assuming a deemed return of 5%, the lawyer has a deemed income of $20,000 on $400,000 worth of assets, significantly below her capital income of $500,000.

65. In the baseline example above, it is highly likely that a large part of the $500,000 dividend from the law company was payment for the shareholder's services as a lawyer. It is difficult to have a definitive way of apportioning a capital and labour component in cases such as this.

66. A method of doing this is used by Norway in its dual income tax, where different tax rates apply for capital income and labour income. It determines the income from capital by imputing a return on the capital value of the business, and treating the income to that extent as capital. Any additional income is income from labour and subject to the higher tax rates.

67. One option for us is to do this and use exactly the deemed return rate as the appropriate rate. In the example above, this would mean that we would treat 5% ($20,000) of the business assets as capital income which could be used reduce the potential additional income and tax from the minimum deemed income regime.

68. A downside of using exactly the deemed return rate is it has no tolerance for timing differences where there is a mismatch between taxable capital income and the deemed return. This is explained more in Appendix 1 with an example of how we propose to address this in the regime using a carryfoward. That adjustment would not completely address the high capital taxable income amounts that may result in some years from timing differences and not represent overall excess returns that are more likely to be labour income. It would be possible to address this with another carryfoward rule which would track the deemed amounts and capital income amounts for each owner-operated business. However, this would add much complexity.

69. We instead propose using this method with the deemed rate plus a margin as the appropriate rate. The deemed rate is the presumptive rate of return on capital used for the minimum tax, and the margin accounts for the fact that the timing of earning capital income for tax purposes does not match the deemed rate on an annual basis[4].

**Example with proposed rule: legal practice**

The lawyer has assets ($200,000 shares in law firm and $200,000 equity in bach), salary ($0), and dividends ($500,000) as in the baseline example above. The deemed rate for the minimum tax is 5%.

Her deemed taxable income amount is $20,000.

Because the lawyer owns shares in a controlled company and performs substantial services towards the business's earning of income, we disregard her dividend income of $500,000. Instead, we assume that she makes a return of the deemed rate of the minimum tax (5%), plus a margin to account for timing mismatches (assumed to be 2%).

This means that we assume a return on her capital assets in the law firm of 7%, or $14,000.

This is less than the deemed taxable income amount of $20,000; and so she has an additional $6,000 of taxable income under the minimum tax.

70. In summary, officials propose:

    70.1 If a person or persons owns shares in a controlled company (including LTC), partnership, or unincorporated business assets; and

[4] The carryforward also does this, but that is only effective if the taxable income was correctly categorized as capital income to begin with.

70.2 The same person or persons also perform substantial services towards the business's earning of income; then

70.2.1 All returns from the business (income from owning assets of a unincorporated business, salaries (including shareholder salaries) from the business, dividends, interest on loans to the business, and net income from partnerships and LTCs) are combined; and:

70.2.2 Taxable income from capital is reduced by the excess (if any) of those total returns from the business, and a deemed return income from those business assets only.

71. Officials will consider an appropriate deemed return and a margin following your consideration of the report on the deemed return amount. Further considering these amounts in consultation following public release of this proposal will further inform the appropriate rates.

## Valuation

72. The valuation of assets to determine whether and how much minimum tax should be paid is a challenging aspect of this tax. Concerns about administrative and compliance costs linked to valuation are part of the reason many OECD countries have repealed these types of taxes.

### General approach

73. We do not recommend valuation methods be prescribed in legislation. Instead, the legislation should refer to an open market value (OMV) approach[5] which is either approved or prescribed by the Commissioner of Inland Revenue.

74. This approach avoids the need to rigidly prescribe valuation methods in the legislation and allows flexibility for the Commissioner to publish valuation methods and update them to reflect modern practices. This approach also allows time to consult on specific valuation methods with stakeholders during the legislative process.

75. It is likely that different valuation methods will be required for each class of asset that makes up a taxpayer's wealth. Any initial advice on valuation methods will be heavily influenced by overseas approaches until consultation can better help determine appropriate methods for the New Zealand context.

76. We recommend that a consultation paper seeking views on proposed valuation approaches for specific assets be published after legislation is introduced.

### Open market value

77. The consensus reflected in international literature and practice is that the OMV of an asset should be assessed for valuation purposes. OMV aims to determine the asset price that buyers and sellers would be willing to purchase and sell for on the open market.

78. There are three main approaches that can be taken to determine OMV (or a proxy for OMV):

78.1 ***Market transactions*** – valuing an asset by way of comparison with a comparable asset for which price information is available. This method is

[5] Or a proxy for open market value

appropriate when a substantially similar asset has recently been sold in a competitive/active market e.g., publicly traded shares or residential property.

78.2 ***Future income*** – present value of expected future cashflows. This method could be used when the income-producing ability of the asset is the critical element affecting value, and reasonable projections of future income are available e.g., private businesses.

78.3 ***Asset cost*** – valuing an asset based on its original cost or the cost of obtaining an asset of equal utility, either by purchase or by construction. This method is typically used for insurance purposes.

79. The market transaction approach is the best approximation of OMV, but would not be possible for some assets, like commercial property, private businesses, and intellectual property. As a result, the future income and asset cost approach would therefore need to be used as a proxy for OMV.

80. It is also possible to leverage off existing, non-tax methods for valuing assets, such as the concept of "fair value" under IFRS standards (see IFRS 13). This concept is also based on OMV and may already be used by a number of taxpayers impacted by this tax.

## Valuing specific asset classes

81. Different valuation methods will be needed when assessing the value of different classes of assets. We continue to research the most appropriate valuation methods for different assets. Our initial thoughts are outlined below[6].

81.1 **Listed companies** - value based on the price listed on the relevant exchange.

81.2 **Private companies and other businesses** – these will be some of the most difficult assets to value. There appears to be two approaches to valuing private businesses in countries with wealth taxes:

81.2.1 valuation equal to the value of assets held by the business entity; or

81.2.2 valuation based on estimated future profits.

There are a number of drawbacks to using these methods, for example a value based on future profits would not be practical for some start-up or loss-making ventures. These approaches may also provide concessionary treatment to those with private businesses. For example, an asset value-based approach will likely undervalue many businesses due to the inability to value assets such as goodwill and intellectual property.

81.3 **Residential property** - value based on independent valuations by registered valuers, rateable values, or approved residential property valuation algorithms which are typically based on recent sales of similar property.

81.4 **Commercial property** - Commercial property (including agricultural property) is likely to be more difficult as algorithms based on recent sales of similar property may not consider certain factors such as whether the

[6] Note, it is difficult to understand the feasibility of these approaches in the New Zealand context without consultation.

property is leased. It is possible a mixture of approaches based on algorithms, future revenue and rateable values could be used.

## Valuation compliance costs

82. Most of the compliance costs imposed by a minimum tax will arise from valuing an individual's net wealth. It is difficult to determine the average compliance costs that may be imposed on individuals without further work on valuation methods and consultation with stakeholders.

83. The compliance cost imposed on individuals will greatly depend on the assets that make up their total wealth. For example, wealth primarily made up of residential property will be lower cost to value as compared to wealth made up from a more diverse mix of assets, including significant business assets.

84. Compliance costs could be reduced by reducing the frequency of valuation, but also from prescribing valuation methods that are practical and leverage off existing valuation tools. These can be explored in more detail through the consultation process. However, we note that there will be tradeoffs involved in terms of fairness and efficiency of the tax.

### *Frequency of valuation*

85. To reduce compliance costs for hard-to-value assets, we could allow taxpayers to use a valuation for a certain number of years, e.g., three years. However, the accuracy of the valuation will decline the longer it is used. Therefore, we may need to allow taxpayers to do more regular valuations if they consider the past valuation overestimates their present wealth.

86. Given assets and wealth tend to increase over time, we could consider applying an annual growth rate to the original valuation. In some situations, this may better ensure valuations remain accurate overtime and provide more comfort with individuals using valuations for a longer period of time, e.g., six years.

87. This concession could either be applied to a person's entire estimated wealth, or just to individual assets that are costly and time consuming to value, such as private businesses. The former would maximise compliance saving while the latter is a more targeted approach which could provide more accurate estimates of annual wealth.

88. We recommend the frequency of valuation be consulted on with the valuation methods in a consultation paper released after the legislation is introduced.

## Treatment of foreign assets

89. You previously agreed that the minimum tax would apply to all assets with certain exclusions. Officials have subsequently considered the treatment of foreign assets further, in particular the treatment of 'controlled foreign companies' (CFC)[7].

90. CFCs currently have an income tax exemption for 'active income' that is not paid to their shareholders as a dividend. This results in a tax deferral benefit until any dividend is paid.

91. Given the objective of the minimum tax is to ensure that wealthy individuals and families pay at least a minimum level of tax on their investment assets that earn a low taxable return, we recommend that the regime apply to all such assets, including those located overseas. Otherwise, the objective could be undermined by

[7] Controlled foreign companies are foreign companies that are owned and controlled by New Zealand residents.

allowing people to own low-taxed assets located overseas. The most common overseas investments owned by individuals and trusts are portfolio shares of foreign companies (taxable under the FIF regime) and foreign land (for example, residential property).

### Controlled foreign companies – active income exemption

92. Some individuals and trusts directly own shares in foreign companies they control (controlled foreign companies or CFCs) although this is not common. Unlike the case for owning shares in portfolio companies which attribute income (a deemed 5%) to New Zealand shareholders each year, no income is attributed from CFCs to New Zealand shareholders as long as the CFC earns primarily active business income. This is the *active income exemption* and is provided so that New Zealand investors are not deterred by New Zealand tax from owning businesses operating overseas which are competing with other businesses whose shareholders are not subject to such tax. Imposing this tax also may encourage investors to migrate since they do not have to be in New Zealand to operate the business.

93. Imposing the minimum deemed income tax on a deemed return from shares in a CFC is inconsistent with the active income exemption. However, we recommend shares in active CFCs be included in the regime as this is consistent with the overall objective of imposing a minimum tax on low taxable-return assets[8]. However, this could discourage investment in overseas businesses.

### Next steps

94. We recommend that you discuss these design decisions with officials at the next Joint Ministers meeting on 7 February.

95. We will report to you again on 13 February on more outstanding design decisions that will need to be made ahead of Budget 2023.

[8] Also, we note that most CFC's are owned through a New Zealand holding company, which may be part of a larger corporate group. Since shares of New Zealand companies are subject to the regime, and the value of the shares of the New Zealand company includes the value of shares of CFCs that it owns, the regime applies indirectly to active CFCs anyway, and it would be very difficult to try to adjust for this.

## Appendix 1 - Annual tax calculation – detailed description

96. You agreed to the basic rules for calculation of the tax on minimum deemed income recommended in the December report. These are:

    96.1 A deemed return on capital assets would be calculated and compared to the taxable income from those assets. If the deemed return is higher, the taxpayer would be taxed on that amount;

    96.2 In order to account for taxes paid at the entity level, a taxpayer with an interest in a PIE or significant interest in a New Zealand company would have the taxable income for the entity attributed to them and treated as if it were part of their taxable income from capital;

    96.3 For businesses in which the controlling owners also perform substantial services towards the business's earning of income, a capital / labour income adjustment may be needed as described earlier;

    96.4 A carryforward account would be used to adjust for timing differences between when taxable capital income is earned versus the deemed income from capital.

97. This section describes in more detail the basic annual calculations that would be required for a person (individual or trust) who is subject to the minimum tax regime for an income year.

98. The basic calculation would be:

    98.1 The deemed return (DR) amount is calculated;

    98.2 The taxable capital income (TCI) is also determined;

    98.3 An adjustment to TCI may be made to attribute company income from significant interests in New Zealand companies. This adjustment may either increase or reduce TCI;

    98.4 An adjustment to TCI is required for investments in controlled business for which the taxpayer performs significant personal services (this adjustment may only reduce TCI);

    98.5 If DR is greater than TCI:

        98.5.1 the difference is the deemed return adjustment (DRA);

        98.5.2 the DRA is added to annual net income;

        98.5.3 the DRA is added to a carryfoward account, the DRA adjustment (DRAA) account;

    98.6 If DR is less than TCI:

        98.6.1 If there is a DRAA amount entering the year, a deduction is allowed for the lesser of the DRAA and the amount by which TCI exceeds DR; and

        98.6.2 The DRAA is reduced by the amount of the deduction.

### Calculating the deemed return amount

99. The deemed return amount is the total calculated value (determined under rules to be prescribed) for all included capital assets at the first day of the income year

multiplied by the annual capital deemed return rate. For the purposes of this report, we assume the rate is 5%.

**Calculating taxable capital income**

100. Taxable capital income (TCI) is annual net income calculated only with respect to net income and loss from capital investments (e.g., interest and financial arrangement income, dividends, foreign investment fund (FIF) income, attributed CFC income, rents, royalties, and gains and losses from the sale of revenue account properties, net income from partnerships and look-through companies and income from unincorporated businesses).

101. Some elements of taxable capital income would include types of income typically thought of as labour income. These would be salaries (both PAYE salaries and shareholder-salaries) from controlled companies and partnerships with respect to which the capital/labour apportionment described earlier would apply. The reason is salaries in these circumstances could in substance be a labour return, or a capital return, or a combination of both.

**Adjustment for significant interests in New Zealand companies**

102. An individual operating a business which they have a substantial interest in has a choice of operating the business by directly owning the assets of the business, or by owning it through a company. A company is often preferred to separate the business and personal assets of the person, and it also affords limited liability. The tax system is designed not to interfere with this choice to the extent possible. For example, the imputation system ensures that a person does not pay more tax through operating a business through a New Zealand company than if they owned the assets directly.

103. Unless special provisions were made, the minimum tax has the potential to discourage use of companies. Because income taxed at the company level that is not distributed as a dividend is not part of the shareholder's taxable capital income, they may have to pay additional tax on deemed income from owning the shares. This would not happen if they conducted the business without using a company, or paid all their current company profits as a dividend. We do not want the tax system to interfere with either of these choices.

104. We are proposing an adjustment to TCI so that:

104.1 If a shareholder owns at least a 10% voting interest in a New Zealand company;

104.2 The shareholder may elect to increase their TCI by their share of the company's taxable income earned during the year; and

104.3 To prevent double counting, they must also reduce TCI by the gross dividend income from the company during the year.

104.4 If the company owns subsidiaries, we are proposing the following simplified consolidation approach:

104.4.1 If the company is part of a tax consolidated group, then consolidated taxable income would be used;

104.4.2 If it has 100%-owned subsidiaries outside of a tax consolidated group, then the taxable income of those companies will be added to the parent's taxable income, pro-rated by the portion of the income year during which the parent owned it;

104.4.3 If the subsidiary is less-than 100%-owned, then no additional adjustments would be made, since dividends paid to the parent would be included in the parent's taxable income.

105. Once the election is made, it would be binding for all future years until the regime no longer applies to the taxpayer. This is to prevent timing dividend payments in order to overstate TCI over a period of years. The proposal to limit the treatment to persons owning at least 10% of the company reflects the fact that unless they are a substantial owner, they may be unable to know the company's taxable income; and also a smaller shareholder would be unlikely to be a person who could influence a business's choice to incorporate or the timing of dividends.

106. The details of this proposal will benefit from consultation.

**Carryforward adjustments**

107. It is likely to be common that the deemed return will differ from taxable capital income in some years because of timing differences where taxable income will arise later in the period of the investment. Examples of these include new businesses with start-up losses, and businesses where income is not recognised until years after a period of value appreciation, such as forestry. In order to address overtaxation because of these timing differences, we are proposing a general carryforward that would track:

107.1 When additional income is recognised because DR exceeds TCI, that would be accumulated in a carryforward account, DRAA; and

107.2 In years when TCI exceeded DR in a year, then the taxpayer would be allowed a deduction for the excess to the extent of available DRAA coming into the year.

108. For example, assume a taxpayer has one capital asset, a forestry investment that appreciates at 5% per year. After 5 years, the forest is sold at the market value at that time. The calculations would be as follows:

| Year | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| BOY MV | $5,000,000 | $5,250,000 | $5,512,500 | $5,788,125 | $6,077,531 |
| 5% appreciation and DR | $250,000 | $262,500 | $275,625 | $289,406 | $303,877 |
| EOY MV | $5,250,000 | $5,512,500 | $5,788,125 | $6,077,531 | $6,381,408 |
| Realised gain/TCI | $0 | $0 | $0 | $0 | $1,381,408 |
| DRA | $250,000 | $262,500 | $275,625 | $289,406 | $(1,077,531) |
| DRAA EOY | $250,000 | $512,500 | $788,125 | $1,077,531 | $0 |
| Additional income | $250,000 | $262,500 | $275,625 | $289,406 | $(1,077,531) |
| Taxable income | $250,000 | $262,500 | $275,625 | $289,406 | $303,877 |

109. In this case, the taxable income in year 5 may be reduced by all of the deemed income recognised in prior years, meaning only the capital appreciation for year 5 is included in taxable income for that year[9].

[9] For the example, choosing a capital appreciation rate that exactly equaled the DR rate was done to illustrate solely the timing effect; if the DR rate and the actual income/appreciation are different there may still be overall differences in the final tax result because of the minimum deemed income regime.