Tax Working Group

Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Appendix 1: Types of business entities in New Zealand and how they are taxed

Background Paper for Sessions 6 and 7
of the Tax Working Group

This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

The Tax Working Group will release its interim report containing its recommendations in September and the views of the Group will be informed by public submissions alongside Secretariat advice.

March 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

TABLE OF CONTENTS

1. Introduction 4

1.1 Structures used by businesses 4

1.2 Comparison of entity tax treatments 6

2. Issues 8

2.1 Comments 8

1. Introduction

1.1 Structures used by businesses

1. Businesses earn income either directly or through various structures, such as companies, partnerships, and trusts.

    - ***Sole trader*** – No liability protection, and profits and losses directly form part of the individual owner's income, with capital gains being generally tax-free. Often used for small start-ups, where only one person is involved.

    - ***Partnership*** – Still in effect operating as individuals but with collective responsibility. A partnership enables resources to be pooled in a formal arrangement. It is an example of a look-through vehicle for tax purposes, with partnership profits being allocated to each partner according to their share of the partnership, and taxed as part of their individual income. Losses and capital gains similarly flow through, with capital gains generally being tax-free in the hands of the partners.

    - ***Look through company (LTC)*** - A tax specific entity designed to reduce the impact of tax on the decision whether to incorporate. It provides the benefit of company status (limited liability) for other than tax purposes. For tax purposes, the treatment is akin to that of a partnership.

    - ***Limited partnership*** – A special form of partnership that has limited liability but partnership treatment for tax purposes. Initially intended as a vehicle to help facilitate investment into New Zealand.

    - ***Trust*** – Provides a means of settling and protecting assets. A trust is not a separate legal entity – instead a trustee effectively acts as "owner" and has an obligation to the beneficiaries. Income earned by a trust is taxed either as trustee income (at 33%) or distributed as beneficiary income and taxed at the respective beneficiaries' marginal tax rates. With ordinary ("complying") trusts, capital gains can be distributed tax-free but losses cannot be distributed. Trusts became increasingly popular during the 2000s, especially in the SME sector where former family owned companies were placed in the ownership of trusts, because the top personal tax rate was 39% and the trust rate was 33%. The 2010 tax reforms removed this incentive by aligning the two tax rates.

    - ***Company*** – The most common form of business structure. It provides the benefit of limited liability so many sole traders become companies for that reason. For tax purposes an imputation system applies. Company profits are taxed at a separate rate - currently 28% - but the company can provide their shareholders with a credit for the tax paid by the company when profits are distributed as dividends. This results in distributed company profits being taxed at shareholders' marginal rates. Losses are ring-fenced in the company so they can only be used against future profits. Capital gains are generally not taxed at

the company level but are only able to be distributed to shareholders tax-free on the liquidation of the company. Otherwise they are taxable when distributed as there will be no imputation credits to attach.

- ***Qualifying company*** - An early form of look-through vehicle. No new qualifying companies can be formed, but qualifying companies in place in 2011 are grand-parented. A qualifying company allows tax preferences to be passed through to shareholders. In a normal company, dividends paid from profits that have not been taxed at the company level are fully taxed when paid to shareholders as unimputed dividends. By contrast, in a qualifying company the unimputed portion can be paid out to shareholders tax-free.

- ***Maori authorities*** – Taxed on a similar basis to a company except the tax rate is 17.5%.

- ***Other entity specific regimes*** – Cooperatives and statutory producer boards, FIFs and CFCs, superannuation funds, life insurers and PIEs.

1.2 Comparison of entity tax treatments

	Direct ownership	General partnership	Limited partnership	LTC	QC	Trust	Company	Maori authority
Ownership rules	N/A	No restrictions	No upper limit on number of partners but must have at least one general partner, and one limited partner	Five or fewer look-through owners (under review)	No new QCs allowed Existing QCs must have five or fewer shareholders including associates	No restrictions on settlors or beneficiaries	No restrictions	Restricted
Different ownership rules / class of shares	N/A	Partnership agreement could provide for different rights for different partners	Partnership agreement could provide for different rights for different partners	Only one class of share allowed	Multiple classes of shares allowed	Trust agreement could provide for different rights for different beneficiaries	Multiple classes of shares allowed	N/A
Owner's liability	Unlimited	Unlimited	Limited	Limited	Limited	Limited for beneficiaries, unlimited for trustees	Limited	Limited
Tax rate	Owner's tax rate	Partners' tax rates	Partners' tax rates	Shareholders' tax rates	Company tax rate on accrual, adjusted to shareholders' tax rates on distribution	Trustee income taxed at equivalent to top personal rate, beneficiary income taxed at beneficiaries' tax rates	Company tax rate on accrual, adjusted to shareholders' tax rates on distribution	17.5 per cent, adjusted to shareholders' tax rates on distribution
Losses	Available to owner	Available to partners	Available to partners subject to loss limitation rules	Available to shareholders	Quarantined to company	Quarantined to trust	Quarantined to company	Generally quarantined to Maori authority but may be offset against net income of another Maori authority
Capital gains	Never taxed	Never taxed	Never taxed	Never taxed	Never taxed	Never taxed	Not taxed on accrual, may be taxed on distribution	Never taxed
Ownership changes / restructures	Owner taxed on revenue account gains / losses and depreciation adjustments	Partners taxed on share of revenue account gains / losses and depreciation adjustments subject to de minimis rules	Partners taxed on share of revenue account gains / losses and depreciation adjustments subject to de minimis rules	Shareholders taxed on share of revenue account gains / losses and depreciation adjustments subject to de minimis rules	Not taxed (unless shareholder holds shares on revenue account)	Not taxed (beneficiaries' rights could be changed by varying trust agreement)	Not taxed (unless shares are held on revenue account) Shareholder continuity requirements apply – if breached, losses and imputation credits are forfeited	As for companies

Statistics on number in each of the above categories

Entity	Number	Taxable income ($m)
Sole traders	469,000	28,340
Ordinary partnerships	97,500	3,730
Limited partnerships	1,800	180
Look-through companies	48,000	-50
Qualifying companies	53,400	1,800
Trusts	254,100	12,700
General Companies	322,300	39,360
Maori authorities	4,000	230

2. Issues

2.1 Comments

2. This variety of vehicles arises through a commercial desire for a range of different ownership structures, and a desire to reduce the impact of tax on decisions such as the decision whether to incorporate. Other countries also have a mix of transparent and separate entity tax treatments for business.

3. Although this may seem complex, there are only really three basic models – individual/partnership treatment (where income is attributed directly to the individuals), standard company tax treatment (where income is taxed initially at the company level but ultimately at the individual owners' tax rate on distribution), and trusts (where income is taxed either as trustee income or beneficiary income). The other types of entities are variations on these basic structures.

4. Ideally, the combined tax paid on income earned through these different arrangements should be consistent unless there are good policy reasons not to do so. Differences in treatment create an incentive for taxpayers to shop among the tax regimes, resulting in economic costs, so the aim is to minimise those costs. Accordingly, much work has been done over recent decades to make the outcomes broadly consistent and to reduce the impact of tax on decision-making when transitioning between the various structures. For example, an imputation system was introduced to reduce biases associated with the former classical company tax system.

5. Nevertheless, as shown in the preceding tables, there are some differences between the various models, the treatment of capital gains and losses for example. In many cases there will be legitimate commercial drivers for a particular structure, but inevitably there will be instances where tax differences will drive choices around business form and where this may be reducing the efficiency and coherence of the tax system. An issue is what can be done in the tax rules to address tax driven arrangements without impeding legitimate commercial situations.