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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 4: Closely-Held Companies

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

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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 Treasury

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Executive Summary

The paper concentrates on the taxation of closely-held companies and, in particular, on differences in taxation that arise from individuals holding investments in entities rather than directly. Business owners often hold investments through entities such as companies and trusts for commercial reasons. Differences in the tax treatment of entities and individuals can lead to differences in the amount and timing of tax, depending on the arrangements made to hold the investments and distribute income.

Tax changes here can have important effects on fairness and social capital by reducing the opportunity for some very high income earners to sidestep paying tax at higher marginal rates. They can also boost productivity by increasing the efficiency of financial/physical capital. Improving tax settings here is important in creating flexibility for future governments. Currently New Zealand has a very small gap between its company tax rate and top personal marginal tax rate by international standards. Any increase to personal income tax rates is outside the Terms of Reference for the Tax Working Group (the Group). But future governments may wish to either increase the top personal marginal tax rate or to lower the company tax rate and the tax rules should allow this to happen in a way which does as little damage as possible to fairness or economic efficiency.

The key policy questions raised in the paper are:

- Is the current model of taxing income earned in a closely-held company at the company tax rate with imputation still the best one; or should some form of personal taxation be applied as the income is earned?
- Can the current imputation-based model be made to work in a manner that is fair, efficient, and reasonably simple and certain for taxpayers and the tax administration?

The paper explores the issues in this area and outlines a number of possible approaches.

The potential approaches outlined are:

- A number of technical and administrative measures intended to make imputation work;
- Special taxes on closely-held companies in certain circumstances to prevent the deferral of tax arising from the lower tax rate offered to companies; and
- A reform of the tax rules applying to closely-held companies, so that they are taxed as if the income they earned was received directly by their shareholders and subject to personal taxation.

The questions for the Group are:

- Is the taxation of closely-held companies an area they would like to examine in their Interim Report?
- Do they wish to pursue any of these approaches?
- Are there any other approaches they would like to examine?

1. Introduction

1.1 Implications for social and financial/physical capital

1.1.1 Taxpayers can earn income either directly or through various entities, such as companies, partnerships, trusts, and portfolio investment entities (PIEs). Ideally, the combined tax paid on income earned through different arrangements should be consistent. In fact, there are differences in taxation in response to different policy drivers for the entities. As a consequence, there are possibilities for taxpayers to arrange their affairs to reduce taxes payable in ways that may raise policy concerns. On the other hand, taxes can be increased for certain types of income. These possibilities can have significant implications for achieving important government objectives.

Social capital

The personal tax system contributes to building social capital by achieving a desired distribution of tax across income levels. For example, it may play a role in reducing inequality in the distribution of after-tax income.

Financial/physical capital

Consistent taxation of income earned through entities can contribute to building financial and physical capital by promoting efficient organisation of income earning activities. As discussed in the paper on Capital Income and Wealth Tax, harmonising taxation of income from savings can promote efficiency. One of the most important ways of reducing remaining distortions is to have greater consistency in the tax treatment of income earned through different entities. It would allow businesses to be organised in the most efficient way and, ideally, would mean that the taxes paid on a given level of income do not depend upon that organisation.

At the same time, concerns about the impact of taxation on the incentives to save and invest may lead to tax rates that depart from perfectly consistent levels of tax being paid in all circumstances. This may require provisions to minimise distortions arising from these differences.

These two areas come together when the taxation of entities is combined with the taxation of their owners on income earned indirectly by individuals through their entities. In that case, the provisions for taxation of entities can have a significant effect on the total taxation of individuals in different circumstances.

1.1.2 In addition, the taxation of income earned through entities can vary depending upon the arrangements made by taxpayers. In some cases, the variations in taxation occur due to specific policy decisions. In others, taxpayers are able to arrange their affairs to avoid the intended level of taxation on their income. In particular, there is evidence suggesting that arrangements to avoid taxation of dividends is a growing issue. Background information on the issue of dividend avoidance is given in the accompanying paper of that name.

1.1.3 This area is unlikely to have significant specific implications for natural and human capital.

1.2 Key policy questions

1.2.1 Many of the issues raised in this paper could be addressed by more general policy changes that are considered in other papers. For example:

- Problems associated with differences in tax rates would disappear if the company tax rate is raised to equal the top personal tax rate (out of scope for the review);
- Problems with capital gains earned in companies would disappear if capital gains were made generally taxable; and
- Problems with imputation and taxation of dividends would disappear if imputation was replaced with full integration.

1.2.2 In the absence of these more general changes, this paper looks at the taxation of closely-held companies where, as outlined below, there are particular challenges to achieving coherent taxation. While ideally it would be desirable to tax closely-held and widely-held companies consistently, the paper examines how best to address tax integrity and fairness concerns for closely-held companies if this is not viable.

1.2.3 The taxation of closely-held companies has important policy implications. The taxation of income earned through closely-held businesses plays a crucial role in determining the distribution of tax, given that many high wealth individuals hold their assets and earn their income in that manner. At the same time, small and medium sized businesses are also affected by the rules. The challenge is to design a regime that helps achieve the distributional goals of the Government, while providing a good platform for businesses to operate.

1.2.4 The current system is under tension because of differences in tax rates and tax bases between closely-held companies and individual shareholders. The fundamental questions raised in the paper are:

- Is the current model of taxing income earned in a closely-held company at the company tax rate with imputation still the best one; or should some form of personal taxation be applied as the income is earned?
- Can the current imputation based model be made to work in a manner that is fair, efficient, and reasonably simple and certain for taxpayers and the tax administration?

1.2.5 The related policy question of bringing the taxation of PIEs more in line with investment income earned directly by individuals will be discussed in a future paper.

2. Imputation and closely-held companies

2.1.1 Since the late-1980s, imputation has been an important part of New Zealand's taxation of companies and their shareholders. Imputation policy recognises that (domestic) companies earn income and bear tax on behalf of their shareholders. It rejects the classical taxation view that companies, in themselves, are a target for taxation. Taxing companies is a necessary proxy for taxing the income of the shareholders[1]. If there was no tax on companies, individuals could accumulate earnings in companies for many years without paying tax as the earnings accumulate. Taxing companies prevents or reduces deferral of tax, and is simpler than taxing companies on a "fully integrated" (or partnership) basis and attributing all of the income of a company to its shareholders as the income is earned. In the absence of dividends, the company is where the cash flow is found.

2.1.2 The imputation system was introduced to ensure that there was no double taxation of income earned through companies. When rates were aligned it worked extremely well. There was no deferral of tax. And companies had an incentive to pay out dividends so that shareholders on lower rates would benefit from a refund of the higher company tax. The system was facilitated by allowing the payment of taxable bonus issues, so that companies could distribute imputation credits while retaining cash if they wished.

2.1.3 When imputation was introduced, it was recognised that an alternative option was full integration, where income would be calculated for the company, but would be taxed at the level of the shareholder. In a sense, full integration was regarded as the gold standard. But there were practical issues with its implementation when companies had different classes of shares, there were corporate chains, or where shareholdings changed during the year. In these cases, there were difficulties with allocating income to shareholders and aligning cash flows and the liability for tax. In the end, imputation was chosen.

2.2 Applying personal tax rates

2.2.1 As income is earned it is taxed at the company tax rate. If the company tax rate is less than the personal tax rate of the shareholder and no dividend is paid there is a deferral of tax.

2.2.2 When a dividend is distributed, it is taxable at the personal level. The imputation credit is deducted from the personal taxes that would have been paid on the underlying income. The net personal tax is equal to the difference between the personal and company tax rates applied to the underlying income. If the company tax rate exceeds the personal tax rate, then the credit can be used to reduce taxes owing on the other income of the shareholder. If the company tax rate is less than the personal tax rate of the shareholder, the shareholder must pay the difference. If no taxes have been paid in the company on the underlying income, then full personal tax rates apply.

[1] The company tax also has the important role of taxing income earned on behalf of non-residents. Taxation of non-residents is not considered in this paper. It, however, is a critical issue in the discussion setting the level of the company tax rate and is discussed in a separate paper.

2.2.3 In effect, imputation means that the personal tax rate replaces the company tax rate (it may be higher or lower) and income that is not taxed at the company level is taxed when it is received by the shareholder. These effects are deferred until the income is paid out as a dividend.

2.3 **Tax back of preferences**

2.3.1 The tax base under the imputation system departs from full integration. Unimputed dividends are taxed in full at the level of the shareholder, so that company level preferences are taxed back. Under full integration, the preferences would flow through to the shareholders to the extent that they were also contained in the personal tax base. Under imputation, the preferences could have been flowed through by exempting unimputed dividends from tax at the personal level. This treatment was original proposed by the Treasury. This is similar in result to full integration.

2.3.2 The principal reasons that pass-through of preferences was rejected were:

- Imputation is a backstop to the company tax system since strategies to reduce company taxes must be "paid back" upon distribution. Companies may wish to maintain consistent dividend streams and so may wish to be able to pay imputed dividends.
- As part of this backstop role, imputation taxes back company level preferences including exempt capital gains and exempt active offshore income.

Tax back of capital gains

2.3.3 The tax back of preferences is a conscious rejection of the principle that the form in which assets are held should not affect the tax results. It means that capital gains are not taxed if the assets are held by shareholders directly, but they are taxed (eventually) if they are earned in a company and then distributed as dividends. One argument for taxing back capital gains is that there are many ways that income can be turned into capital gains. For example, selling a foreign subsidiary converts a pool of exempt active offshore income into a capital gain. Taxing back capital gains therefore protects the domestic tax base.

Tax back of offshore income

2.3.4 The policy underlying the tax back of the active offshore income exemption is somewhat clearer. Imputation taxes back the active income exemption and the foreign tax credits that reduce tax at the company level. This was an intentional effect. Similarly, the active income exemption is not available to individuals. The tax back also provides protection for the domestic company tax base. For domestically-based multinationals, there is a benefit to paying New Zealand taxes rather than foreign taxes in being able to impute dividends.

Flow out of losses

2.3.5 When a business is unincorporated, any losses that arise can be offset against the owner's income from other sources. However, if the business is operated through a company, losses at that level cannot be used to offset personal income of the shareholders. Especially for start-up companies, this can be an

impediment to incorporation. Companies can sometimes work around this issue; perhaps by holding debt at the personal level, but it can be problematic.

2.3.6 How to treat losses raises many issues. On the one hand, bottling up losses raises effective tax rates on investments and inhibits new entrants compared to established companies. On the other hand, passing out losses can allow tax sheltering and introduces revenue risks.

2.3.7 As noted in the next section, New Zealand has allowed losses to be flowed out in some circumstances.

2.4 Special regimes for closely-held companies

2.4.1 These implications were controversial for closely-held companies. There has been longstanding pressure for such companies to be able to pass out exempt income (mainly capital gains) earned at the company level to shareholders free from tax, especially for closely-held companies. In partial response to this, Qualifying Companies (QCs) and Loss Attributing Qualifying Companies (LAQCs) were introduced in the early 1990s. For these companies, tax preferences could be passed out tax free, and for LAQCs losses at the company level could be used to offset income at the shareholder level.

2.4.2 At the time of introduction of QCs and LAQCs, the top personal, trust, and company tax rates were all aligned at 33 per cent. This alignment was broken in 1999. After that time shareholders of such companies could benefit from facing a lower tax rate than their personal rate making them better off than unincorporated enterprises. At the same time (unlike those investing in ordinary companies), they faced no tax back of tax preferences. The Budget of 2010 addressed this anomaly by replacing QCs and LAQCs with Look Through Companies[2], (LTCs), which have a form of partnership taxation. For an LTC, income is taxed at personal tax rates and tax preferences and losses of the company are available at the personal level. This change was controversial and so the area was in flux until 2016 when modifications to the LTC rules were introduced.

2.4.3 The resulting system is a compromise. For certain closely-held companies (LTCs), the tax system can be fully integrated at the option of the shareholders. Tax is paid at the personal tax rate and those preferences that are available to individuals are preserved for shareholders. That is, capital gains are exempt from tax. But for other companies (more than five shareholders, majority foreign-owned, earning significant foreign income or publicly listed), company taxation is applied as income is earned with imputation for distributed dividends.

[2] An LTC, similarly to a QC, must have five or fewer shareholders and cannot hold significant foreign assets.

3. Integrity issues

3.1 Categories of issues

3.1.1 The combination of the different tax rates and bases of companies and individuals with dividend avoidance raises three linked issues:

Deferral of the top personal tax rate

Consider $100 earned within a company owned by an individual at the top personal marginal tax rate. It is taxed at the company tax rate of 28%, so $28 is paid in tax, for an after-tax income of $72. Had the income been earned directly, $33 of tax would have been paid for after-tax income of $67. When the after-tax amount of $72 is distributed as a dividend to a shareholder, a further $5 of personal tax is paid, for a total of $33, which is the same amount of tax as if the income had been earned directly by the shareholder. The additional tax impost can be deferred by retaining the income in the company rather than paying a dividend

Avoiding the top personal tax rate

Under a dividend avoidance arrangement, the additional $5 of tax is avoided. Dividend avoidance allows the value associated with the retained earnings to be distributed without payment of the tax.

Avoiding the tax back of preferences

When income on which no tax has been paid is distributed as a dividend it is "unimputed". When an unimputed dividend is received by a shareholder it is subject to full personal taxation ($33 for a top rate taxpayer) as there is no imputation credit available to reduce the personal tax. In this case, dividend avoidance would result in $33 of tax being avoided.

3.2 Types of income

3.2.1 Differences in company and personal tax rates can open the possibility for differences in taxation for a number of types of income. Policy concerns and solutions may differ for each and some countries have different tax rules for these different forms of income. An important question for New Zealand is whether or not it should also have different rules for these different forms of income. Answers may depend on the size of the gap between the company tax rate and the top personal marginal rate as well as other protections including whether or not we have a capital gains tax. The different types of income include:

Business income

A deferral advantage can be gained by operating a business through a company, rather than an unincorporated business, as income is taxed at the lower company tax rate rather than the higher personal tax rate. This allows a deferral of tax (for a top marginal tax rate owner) as long as the income is retained in the company.

Incorporated portfolio

Personal financial assets can be placed into a company in order for the accumulating investment income to be taxed at the lower company tax rate. The tax reduction can be a deferral or permanent, depending on whether the income can be distributed without dividend taxation.

Excess retentions

The above issues are combined in the issue of excess retentions. In this case, business income is earned and taxed at the low company tax rate, but it is not reinvested in business assets. Rather, it is invested in passive assets. This has two benefits relative to paying the funds out as a dividend and holding the investment directly. First, it defers the recapture of the tax benefit of applying the lower company tax rate to the original business income. Second, it allows the lower company tax rate to apply to the accumulating investment income.

Incorporated employee/personal service income

Tax benefits can be realised through the diversion of employment/personal service income from the personal tax system to tax preferred structures.

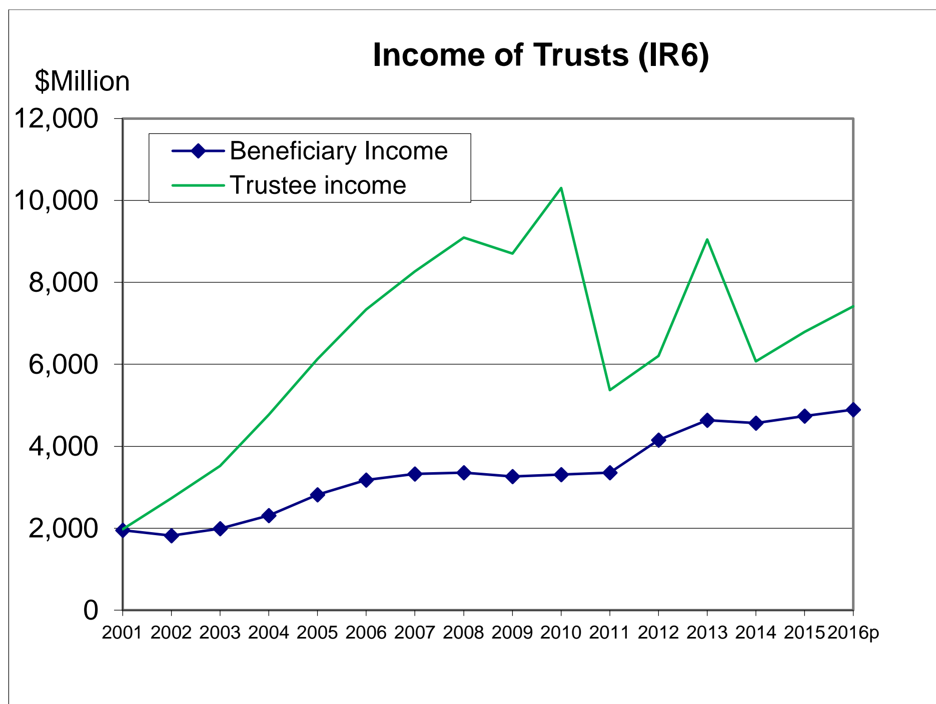
4. How big is the problem?

4.1 Recent trends

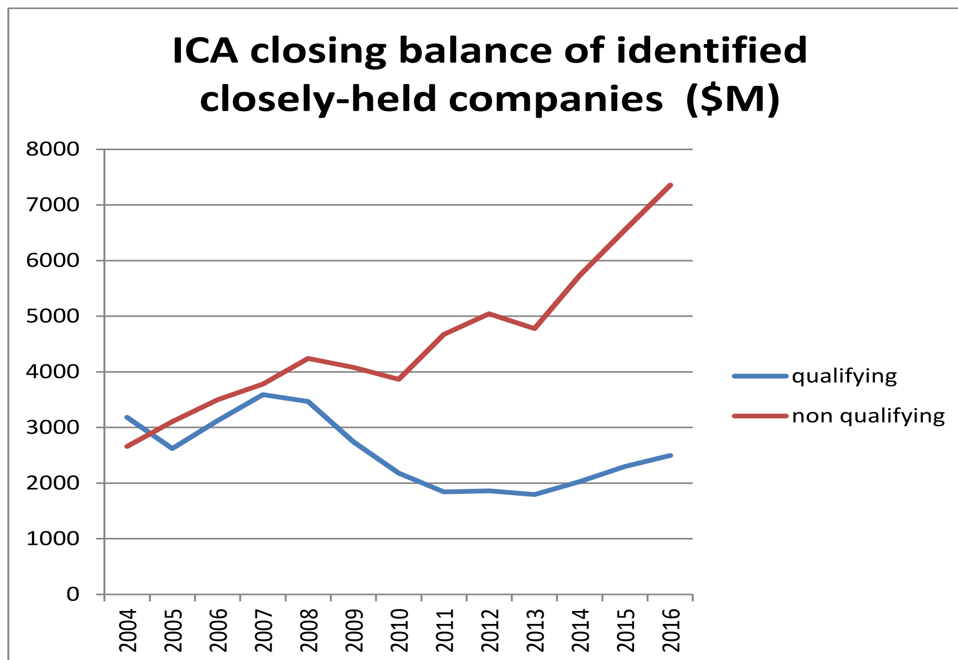
4.1.1 The effect of these issues between 1999 and 2010 has been documented in a number of Inland Revenue's Briefings to Incoming Ministers (BIMs). Problems that were identified included:

- the top personal tax rate did not stick, frustrating the desired incidence of the personal rate schedule;
- as these strategies are more available to higher income individuals the fairness of the tax system is compromised;
- inefficiencies arose from different tax rates being applied to different entities; and
- there was a loss of government tax revenue.

4.1.2 The principal source of problems arising from differences in tax rates prior to 2010 was that the trustee tax rate was 33%, while the top personal tax rate was 39%. Unlike companies, the distributions from the trust can be made free from personal tax so that the trustee tax rate is a final tax rate. Because of this difference, there was a substantial permanent tax benefit from earning business income through a trust rather than directly or through a company. The BIM documented a substantial rise in the amount of trustee income prior to 2011 as taxpayers arranged their affairs to take advantage of these differences. In 2011, the trustee tax rate was aligned with the top personal tax rate and since then trustee income has fallen, while income of closely-held companies has increased substantially. The following table illustrates the trends of trustee income.

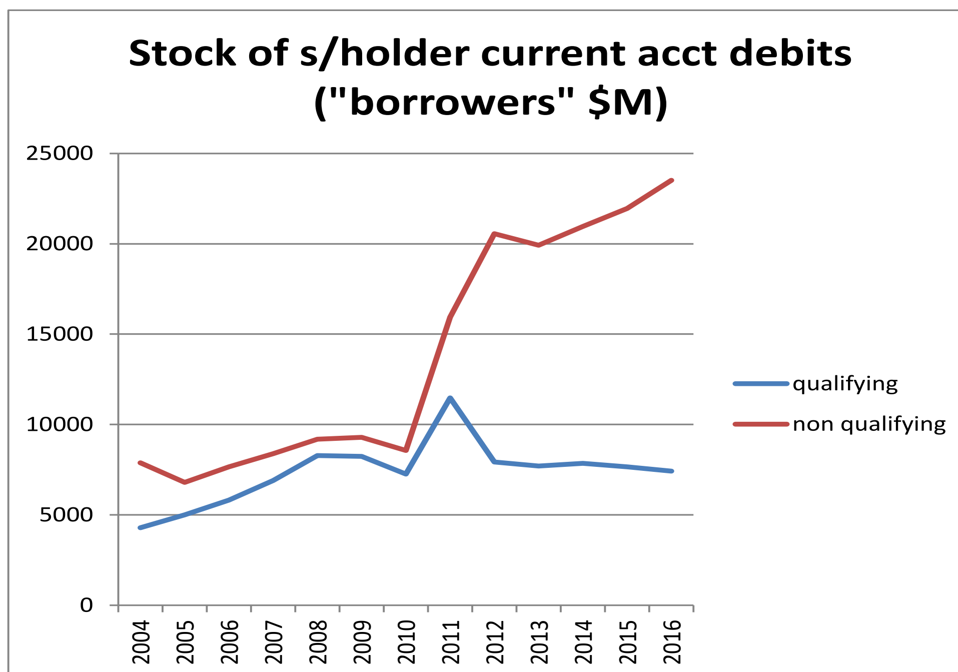


4.1.3 The 2011 changes retained a gap between the company and the top personal tax rate. Data on closely-held companies is not fully distinguishable from other companies, so it is difficult to determine total amounts. However, it has been possible to identify a sub-group of such companies[3]. It appears that there have been changes in behaviour in reaction to the changed tax rates. In particular, retentions of taxed income appear to have increased sharply since 2011. Such retentions would benefit from a deferral in the application of the personal tax rate. This trend is illustrated in the table on increases in Imputation Credit Account (ICA) closing balances.



4.1.4 At the same time, funds withdrawn from taxpayers' current accounts have risen substantially. Current accounts are loans from companies to their shareholders. This is illustrated in the table on the stock of current account debits. These increases suggest that shareholders are borrowing to access corporate income, rather than being paid dividends. Overdrawn shareholder current accounts are not necessarily a problem if tax rules are fully complied with and the loans are repaid. However, their rapid build-up raises concerns around whether current accounts are being used appropriately.

[3] As noted above, qualifying companies (QCs) have different rules for taxing dividends. Since 2010, no further QCs can be established and a subset of QCs, the LAQCs, have been removed.



4.1.5 Finally, it should be noted that Inland Revenue audit staff have observed an increase in dividend stripping arrangements that have been the subject of the recent tax alert (see paragraph 5.2.2 below).

4.2 Measuring tax deferral benefits

4.2.1 Benefits from rate differences accrue to taxpayers when their personal income can be made subject to a tax rate which is less than their personal tax rate. The effective rate reduction can be permanent, when the reduced rate is a final tax (perhaps through the use of a dividend avoidance arrangement), or a deferral, when all income is eventually taxed at the full personal rate, but a portion of the tax is delayed relative to the earning of the income.

4.2.2 Four structures are examined.

Dividend avoidance

Income is earned in a company and is subject to tax at the company rate. The after-tax income is accumulated in the company and an arrangement is found to extract the cash from the company without triggering dividend taxation. Accordingly, the company tax is a final tax and a permanent tax benefit (the difference between the company rate and the top personal tax rate) is conferred.

Company owned by a trust

Income is earned in a company that is owned by a trust and the after-tax investment income is retained in the company until a dividend distribution is made to a trust where the grossed-up dividend income is taxed at the trustee tax rate with an imputation credit. The trustee tax rate is a final tax rate and the tax benefit of the structure is a combination of deferral (the difference

between the company and the trust rate) and permanent (the difference between the trust and the top personal tax rate, if any).

Imputation

Income is earned in a company and the after-tax income is retained in the company until a dividend distribution is made to an individual where the grossed up dividend income is taxed at the personal tax rate with an imputation credit. The tax benefit of the structure (for an owner on the top personal tax rate) is a deferral (the difference between the company and the personal rate on the accumulating interest income) and not permanent, (since the top personal tax rate ultimately applies to all income).

Direct taxation

The income is earned by the individual and income is taxed at the personal tax rate as it is earned. This is the baseline against which the other structures are measured.

4.2.3 Consider three different rate structures.

	Top personal rate	Trustee tax rate	Company tax rate
1999 Rates	39	33	33
2011 Rates	33	33	28
Personal rate increase[4]	39	39	28

4.2.4 The following table shows the percentage increase in the accumulated after-tax income that can be realised by a taxpayer through the different entity arrangements. In this case, personal income is earned and taxed in the entity and then either paid out immediately or retained for 10, 20, or 30 years.

[4] While this possibility is outside the Terms of Reference, it is included to show what would happen if a future Government decided to increase the top personal rate. A future cut in the company tax rate would give rise to similar integrity pressures.

4.2.5 Benefit Relative to Full Personal Taxation				
1999 Rates				
	No deferral	10 year deferral	20 year deferral	30 year deferral
Dividend Avoidance	10%[5]	13%	16%	19%
Trust	10%	13%	16%	19%
Imputation	0%	3%	6%	9%
2011 Rates				
	No deferral	10 year deferral	20 year deferral	30 year deferral
Dividend Avoidance	7%	10%	13%	15%
Trust	0%	2%	5%	7%
Imputation	0%	2%	5%	7%
Increased top personal tax rate				
	No deferral	10 year deferral	20 year deferral	30 year deferral
Dividend Avoidance	18%	24%	31%	38%
Trust	0%	5%	11%	17%
Imputation	0%	5%	11%	17%

4.2.6 With the 1999 rate structure, there was no advantage to dividend avoidance relative to using a trust. Use of a trust could increase the after-tax cash flow from 10% to 19% depending upon the deferral period.

4.2.7 The 2011 rates eliminated the major structuring benefit resulting from using a trust to earn the income. The deferral benefit from using a company was slightly reduced. Once again, there are substantial benefits to be earned by avoiding dividend taxation.

4.2.8 After 1999, and apparently again after 2011, these differences have been sufficient to significantly change taxpayer arrangements and behaviour.

4.2.9 Either a substantial increase in the personal tax rates or a sharp reduction in the company tax rate would increase benefits from structuring. The table shows that if profits are retained for a long period of time, increasing the top personal marginal tax rate to 39% combined with the current company tax rate of 28% would approximately double the benefits of dividend avoidance or of retaining income in a company and then paying a dividend relative to what would have been true in 1999.

[5] $100 of income earned directly, paid tax of 39, for a net income of 61. Income that was only subject to the company tax rate paid 33 of tax, for net income of 67. 10% = (67-61)/61.

5. Approaches to taxing closely-held companies

5.1.0 The gap between tax rates may increase in the future. In examining the following approaches, it is useful to consider if a greater gap would change the relative priorities among them and whether it would be appropriate to put in place the approach that would be the most robust to future changes.

5.1.1 The approaches are arranged in increasing radicalism relative to the current system. "Making the imputation system work" involves technical changes to the current system, while the "reform option" would be a fundamental change to the taxation of closely-held companies.

5.2 Making imputation work

> If you think that the imputation policy settings are fine, but are worried about dividend avoidance, you could enhance technical rules to make the imputation system apply when value is taken out of a company.

5.2.1 There are a number of initiatives that could be taken to address dividend avoidance.

Administrative responses

5.2.2 Inland Revenue is already responding at the administrative level to the challenge of dividend avoidance. On 13 March 2018, a revenue alert was released on dividend stripping (dividend stripping is discussed in the paper on Dividend Avoidance also distributed for the meeting). A revenue alert presents Inland Revenue's view on an emerging interpretation issue and is intended to advise the public of the department's position so that they can take it into account when planning their affairs.

5.2.3 In the alert, Inland Revenue describes a number of common dividend stripping arrangements that they have encountered in their investigations. The arrangements rely on an interpretation that the sale of shares that form an important part of the arrangements give rise to tax exempt capital gains. It is the department's position that the arrangements described constitute tax avoidance under section BG 1 and possibly section GB 1 and that they consider the sale proceeds in the arrangements to be dividends.

5.2.4 This is an important initiative. Its ultimate success in deterring dividend stripping depends on whether taxpayers accept Inland Revenue's position, whether the fact situations covered can be extended to other arrangements and any judgment if a case goes to court.

5.2.5 Without commenting on these questions, relying on a general anti-avoidance law to fill in holes in the statutory law, if they exist, may fail to achieve the desired policy intent. It can create uncertainty, risk, and compliance cost for taxpayers. It is also resource intensive for Inland Revenue, both in identifying cases, and dealing with them.

Legislative changes

5.2.6 Dividend stripping is only one way of extracting value from a company without paying a taxable dividend. In any event, it would be desirable to make the intention of the law clearer in this situation, in order to provide more certainty to taxpayers.

5.2.7 Areas that would need to be considered include:

- Enhanced dividend stripping rule.
- Available Subscribed Capital (ASC).
- Current accounts.
- Liquidation pay-outs.
- Shareholder loans.

5.2.8 The general questions would be whether transfers of value made to shareholders are considered to be dividends or non-taxable returns of cash or assets; and, if so, in which circumstances?

Effect of general taxation of capital gains

5.2.9 Since many of the arrangements designed to avoid dividend taxation replace a dividend with an exempt capital gain, taxing capital gains would reduce the potential for dividend avoidance in the future. Taxing capital gains as income at full rates would be a backstop to prevent dividend stripping both in the case of dividends that would be unimputed and dividends that would be fully imputed. The key here is that the amount of tax on capital gains should be at least as much as the tax that would apply to the dividend. A tax of 5/72ths would protect against dividend stripping to save the final 5% of tax, but would not to prevent stripping of dividends that would otherwise be unimputed.

5.2.10 However, capital gain taxation would only be applied on a prospective basis, so capital gains that have accumulated prior to the coming into effect of the new tax would remain exempt. Therefore, a dividend avoidance problem would remain for any capital gains that had been earned prior to the introduction of the tax.

5.2.11 Some dividend avoidance strategies do not exploit the capital gains exemption and so would still require technical responses.

5.2.12 An important question is whether amendments in these areas alone would suffice to address current integrity concerns and how big a difference between the company tax rate and the top personal marginal tax rate might be sustained before further actions would be necessary.

5.3 Ensuring taxation of personal investment income

If you are concerned about the deferral of the top tax rate on personal income, you could apply the top personal tax rate to such income as it accrues in a closely-held company.

5.3.1 Deferral benefits arise when investment income is earned in a company so that it is taxed at the company tax rate. These deferral benefits can be removed by imposing special taxes on closely-held companies.

5.3.2 A number of countries have special rules to deal with these issues. Possible initiatives include:

- excess retention taxes;
- special tax rate for investment income;
- personal service company regimes; and
- incorporated portfolio regimes.

5.3.3 If the surtaxes can be appropriately targeted, they would have the following effects:

- They would not claw back tax reductions that were reinvested in the business.
- On the other hand, they would tax back reductions of tax on funds that were accumulated in the company as financial assets on behalf of shareholders in order to avoid taxation of dividends and subsequent tax on investment income.
- They can prevent deferral of tax on incorporated portfolios and personal service companies.

5.3.4 There are many technical issues with these taxes.

5.3.5 An important question is whether additional rules such as these are necessary and how this depends on the gap between the company tax rate and the top personal marginal tax rate.

5.4 Reform of taxation of closely-held companies

If you think that income of closely-held companies should be taxed the same as income earned directly by individuals, you could apply a compulsory (modified form of) partnership taxation to closely-held companies.

5.4.1 Reforms could go in many directions. As noted earlier, some general reforms would have profound effects on this discussion. One question that is not discussed elsewhere is whether switching back to a classical company tax system would fix the problems with dividend taxation.

5.4.2 Countries with a classical company tax system are often less concerned about companies being used to shelter investment income and personal services income from higher rates of personal tax. Double taxation of income earned through companies makes using entities less attractive. But many of the pressures such as making dividend taxation stick would be amplified by a classical company tax system. It is very difficult to defend dividend taxation without a capital gains tax and countries with classical company tax systems tend to have capital gains taxes in support. Moreover, all of the technical issues related to making imputation work would be exacerbated by a classical tax system.

5.4.3 The two tensions, of differential tax rates and the tax back of tax preferences, are at the heart of problems in this area. One way to address both tensions at the same time would be to introduce a system for closely-held companies based on personal taxation concepts. A similar tax system to apply to closely-held companies was raised by the McLeod Review.

5.4.4 The approach can be described in general terms as taxing income earned through closely-held entities as if the income had been earned directly by the owners.[6] The approach would deal with the integrity issues for the type of companies where they are most problematic.

5.4.5 The objective of a system applying to closely-held entities would be that personal income (from business, investment, and personal services) cannot be shifted to entities in order to avoid the top personal tax rate; while allowing preferences that are available at the personal level, such as the exemption for capital gains, to be passed through to owner/shareholders without claw-back by the imputation system.

5.4.6 Various mechanisms are possible, including an extension of the LTC regime to a broader group of companies or the introduction of a new category of company that can pass out preferences (similar to a QC), but taxed at the top personal tax rate.[7]

5.4.7 The important point is that taxpayers would face the top personal tax rate on their income as it accrues. At the same time, tax preferences could be passed out.

5.4.8 With an LTC, these changes happen automatically. For QCs, there is more discretion. All unimputed dividends could flow out tax free, or only certain pools of income might qualify. Consideration would also have to be given to whether losses at the company level should be allowed to offset other personal income of the shareholder. If so, rules would be necessary to limit the possibility of tax shelters.

5.4.9 If the closely-held treatment is optional, there will be an incentive to earn taxable income through ordinary companies taxed at the lower rate; with capital gains and tax preferences earned in closely-held companies. This raises the major policy questions of:

- Which companies should be subject to the new regime?
- Should the regime be made compulsory?

5.5 **Who pays under the different approaches?**

5.5.1 The approaches differ substantially in their impacts on different taxpayers and arrangements. They would have different effects on the distribution of taxation, affecting both social capital and financial/physical capital objectives.

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[6] For the purposes of this section, income earned in non-closely-held companies would continue to be taxed through the company tax and the imputation system.

[7] QCs and LTCs were briefly introduced earlier in Section 2 on Imputation and Closely-held Companies.

Making imputation work

5.5.2 The first approach would raise tax payable on income earned through companies, particularly for more sophisticated companies that are likely to be able to retain earnings and take advantage of more sophisticated arrangements. Arguably, it would impose the level of tax contemplated by the current structure of the tax system. However, since some of the rules have always formed part of the system, they would be regarded as part of that structure by many taxpayers.

Special taxes on closely-held companies

5.5.3 In a business context, the special taxes would generally apply only when companies are able to accumulate funds that are neither needed for distribution to shareholders nor reinvested in the business. They would also apply when the investment income arises from savings that are invested through a company to avoid personal taxation or to facilitate income splitting. They would apply to the investments in funds that are retained in a company and invested in financial assets. As such, they would tend to reduce tax deferral opportunities for higher income individuals.

5.5.4 They would add complexity, but a de minimus threshold could remove the impacts on the smallest companies. Complexity generally arises from the need to target taxation on investment income rather than business income.

Reform of taxation of closely-held companies

5.5.5 Relative to the current system, there would be winners and losers. Individuals who are able to use companies to defer or avoid personal tax rates on their income would experience a tax increase. On the other hand, shareholders with companies earning capital gains would, in principle, receive a reduction in tax since their capital gains could now be passed out to taxpayers free from tax (that is, imputation would no longer apply). This would provide a tax benefit to the extent that taxes on the distributed capital gains were not already being avoided by other means.