Tax Working Group
Te Awheawhe Tāke

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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.*** <br><br> ***The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.*** |

# Appendix 5: Dividend Avoidance

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

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***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.***


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*Prepared by the Inland Revenue Department and the Treasury*

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# 1. Introduction

## 1.1 Context

1.1.1 This paper provides the Group with background material for their information. It reports on recent developments in the taxation of closely-held companies and their shareholders. IRD audit staff have recently encountered a variety of arrangements that, in their opinion, allow taxpayers to avoid the intended taxation of dividends on the distribution of income or assets from companies to their shareholders.

1.1.2 On March 13, 2018, the IRD released a revenue alert describing a number of transactions involving the sale of shares where they would consider the sale proceeds to be dividends and therefore taxable.

1.1.3 The broader policy implications of these issues are explored in the paper on the Closely-held Companies.

## 1.2 General imputation context

1.2.1 The imputation system was introduced to ensure that there was no double taxation of income earned through companies.

### *Personal tax rates apply on distributed income*

1.2.2 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, then full personal tax rates apply.

1.2.3 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.

### *Tax back of preferences*

1.2.4 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.

1.2.5 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.

# 2. Dividend avoidance

## 2.1 **The effect of dividend avoidance**

2.1.1 Dividend avoidance is a means of frustrating the goals of the imputation system. At its simplest, dividend avoidance is an arrangement which allows accumulated profits or company assets to be paid out to shareholders without attracting the tax that would have applied if the profits or assets had been paid out as a dividend.

2.1.2 The simplest forms of a type of dividend avoidance, called dividend stripping, are prevented by specific anti-avoidance rules. However, IRD audit staff have identified a number of arrangements, with a potentially significant revenue exposure, that they consider to be dividend avoidance, which do not appear to be caught by the technical provisions of the Income Tax Act.

2.1.3 Many dividend avoidance arrangements make use of the tax exempt status of capital gains as a step in the arrangement. Generally there is a sale of shares to a related party that does not result in a true alienation of the underlying property or business. Of course, not all sales of shares are dividend avoidance. A sale to a third party, which involves a true transfer of ownership, gives rise to exempt capital gains, but is not considered to be a dividend avoidance arrangement.

2.1.4 Income that has been taxed but is retained in a company enjoys a deferral of tax compared to personal taxation whenever the marginal tax rate of the taxpayer exceeds the company tax rate of 28%. For a top rate taxpayer the benefit would be 5 percentage points of tax. Dividend avoidance converts this deferral of tax into a permanent tax reduction.

2.1.5 Dividend avoidance can result in income that has not been subject to tax being transferred tax-free to shareholders. For example, income retained from exempt capital gains or offshore active income can be in effect distributed. In that case, the amount can be transferred in a manner that avoids tax altogether, therefore avoiding the full 33% of tax.

## 2.2 **How dividend avoidance works**

2.2.1 The transactions that raise concerns generally involve a series of steps, which may include:

- Creation of new trusts and holding companies;
- Sale of shares without changing the ultimate ownership of assets;
- Share for share exchanges, mergers or buyouts;
- Recapitalisation of the company, through loans, with related parties or outside financing;
- Creation of artificial available subscribed capital (ASC);
- Artificial liquidation of the company;

- Value distributed to the shareholder; and,
- The value may be from past retained earnings, future earnings streams, or future realisation of capital gains that have previously accrued.

2.2.2 Untangling these arrangements and relating them to the law is complex for administrators and can introduce considerable uncertainty for taxpayers as they arrange their affairs.

2.2.3 The situation arises when a shareholder owns a company that has gone up in value since it was established. The increase in value may reflect retained earnings (taxed or not), an asset that has appreciated in value (but has not been sold), or the development of a stream of future earnings (so that the business is worth more). The shareholder would like to have access to the increase in value for personal uses.

2.2.4 One way to access the value would be to pay dividends as the cash becomes available. Under imputation, dividends from the previously fully-taxed retained earnings would be exposed to the extra five points of tax arising from the difference between the top personal and company tax rates. Future taxable earnings would face the same tax impost when they are paid out. Untaxed retained earnings and exempt capital gains distributed as dividends on sales of assets would face the full personal tax rate of 33%.

2.2.5 The shareholder would prefer to receive the value free from tax. Dividend avoidance accomplishes this. One way to do this takes advantage of the fact that capital gains on the sale of shares in the company are free from tax.

2.2.6 In the simplest arrangements, an intermediate entity owned by the shareholder is established that is funded by debt. The debt is used to purchase shares of the company from the shareholder, giving rise to a tax-free capital gain.

2.2.7 If the debt is internal to the group, retained earnings or future income can be passed out from the company as a repayment of debt, avoiding the taxation of the dividend.

2.2.8 If the debt is external, it provides the cash to make the repayment of debt and so the cash is distributed without dividend taxation. This is a form of recapitalisation that arguably does not constitute a problem in itself. The problem is that value is paid out to the shareholder without attracting taxation.

2.2.9 In the simplest cases, these arrangements may run afoul of the existing anti-dividend stripping rule in the law. For more complex cases, the IRD has just issued a Revenue Alert. In practice, IRD is observing a number of arrangements with a wider variety of issues and more complicated factual situations than the simplified examples in Alert.

2.2.10 There are also arrangements that take advantage of the fact that capital gains are passed out tax-free on the liquidation of a company. This provision can be used to distribute value in a tax-free manner in situations where a partial liquidation allows assets to be distributed, while the ongoing business assets continue in another company owned by the shareholder.

# 3. Preventing dividend avoidance

## 3.1 Recent Revenue Alert

3.1.1 The IRD is already responding at the administrative level to the challenge of dividend avoidance. On March 13, 2018 a revenue alert was released on dividend stripping. A revenue alert presents the department's view on an emerging issue. It is intended to advise the public of the department's position so that they can take it into account in planning their affairs.

3.1.2 In the alert, IRD describes a number of common dividend stripping arrangements that they have encountered in their investigations. The arrangements rely on an interpretation that the sales of shares that form an important part of the arrangements give rise to tax exempt capital gains. It is IRD'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.

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

3.1.4 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 desired policy intent. It can create uncertainty, risk and compliance cost for taxpayers. It is also resource intensive for the department, both in identifying cases, and then dealing with them. It is a matter for analysis whether some changes in the law are desirable to make the intention of the law clearer in this situation.

## 3.2 Current dividend stripping rule

3.2.1 The law currently has a dividend stripping rule - section GB 1 noted above. At least some taxpayers do not believe that it covers their transactions. It covers a limited type of arrangement, and so the black letter law may not apply to some of the transactions. An extension of the rule could encourage restructuring transactions to be carried out without the dividend avoidance effects. A wider rule could reduce the need to rely on section BG 1 and improve the chances of success in situations where it is applied by the department.

## 3.3 Other means of extracting value

3.3.1 There are other means of extracting value from companies that are not covered by the Revenue Alert.

3.3.2 These include the use of current accounts, creation of available subscribed capital (ASC), shareholder loans and liquidations of companies.