Tax Working Group Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

> ***This paper has been prepared by the independent advisor to the Tax Working Group for consideration by the whole Group.***
>
> ***The advice represents the views of the independent advisor and does not necessarily represent the views of the Group or the Government.***

Companion note – Meeting 14

This note was produced ahead of officials papers being finalised and so some of the comments below may have been incorporated in their work.

Productivity and closely held businesses

In the Productivity Commission's work[1], there is a recurring comment that New Zealand businesses start small and stay small with a lack of 'up or out dynamic'. There are a number of things discussed but I have an unease that there are features of our tax system disincentivise growth as these features are not available to widely held firms.

In particular this is the ability for small businesses to blur the business/personal boundary with a combination of structuring of interest expense, shareholder salaries or beneficiary distributions or straight tax evasion through deducting personal expenditure. Neither are available to providers of labour or widely held businesses.

Interest deductibility

Companies are entitled to full deductibility for all interest expense.[2] Outside a company structure interest is allowed as a deduction is the borrowing is directly connected to an income earning asset. This is also known as *tracing.*

As a result standard tax advice is that equity should be used for all personal assets such as family home and debt should be used for business assets. The family home can be borrowed against to fund business assets but not the other way around. This maximises the tax benefits of the interest expense.

This also means that higher levels of debt can be sustained by the business than otherwise would be the case as there is effectively 'hidden' equity in personal holdings. This will be among the reasons banks require personal guarantees for closely held company borrowing.

Personal expenditure

Strictly speaking all private expenditure paid for by a business should be treated as a drawing or advance on distributions to shareholders.

However if it isn't; this will only be uncovered or reversed on audit which by definition are time consuming for both IRD and the taxpayer. This is particularly the case for Inland Revenue as it will require a detailed review of all business expenditure as the personal expenditure could have almost any classification in the accounts.

---

[1] https://www.productivity.govt.nz/sites/default/files/Achieving%20NZ%27s%20productivity%20potential%20November%202016_0.pdf

[2] However if that borrowing purchased an asset that was used privately by a shareholder the value of the use – effectively imputed rent – becomes a taxable dividend to the shareholder.

Thus if a taxpayer is prepared to play the audit lottery; personal expenditure can reduce taxable income.

All of which is exacerbated by social norms that say such behaviour is ok.

Income splitting

With the top marginal rates in excess of the company tax rate, there is an incentive to pay shareholder salaries to as many people in the household as possible. This is acceptable if the remuneration matches the services that are provided to the business.

Again this can only be assessed through compliance activity by Inland Revenue.

To income split within a company either salaries need to be paid or the capital structure must be organised to pay out different levels of return to different people. These are not constraints in a trust with beneficiaries.

While distributions to beneficiaries 16 and under are taxed at 33%, the earnings of a trust can be distributed to beneficiaries to access their lower rates without having to link this to services or capital provided.

Hidden Economy

Members may like to consider alternative views on the recent BT initiatives at Inland Revenue.

Discussion of the restructure of investigation staff

https://www.stuff.co.nz/business/industries/95309968/fight-against-tax-rorts-may-be-undermined-by-ird-shakeup-labour-fears

Affect on agents including AIM implementation

http://www.radionz.co.nz/national/programmes/ninetonoon/audio/2018646789/ird-changes-cause-more-issues-for-tax-agents

Loss continuity

The loss rules, like other parts of the tax system, are based on the concept that a company is a vehicle for its shareholders. This is then the basis for allowing the carry forward of losses of a company when shareholding is 49% similar or offsetting with other group companies with 66% similarity of shareholding. [Australia requires 100% similarity of shareholding before losses can be offset.]

There is also the ability for look through companies and limited partnerships to pass its losses to its shareholders or partners respectively.

Small R&D intensive companies can have its losses cashed out up to a cap. More generally losses are not cashed out but that effect arises through their use against group company profits.

Otherwise losses are carried forward to use against future profits so long as 49% of the shareholders are the same between generating the loss and earning a profit.

The secretariat paper – and also the Tax Work Programme – proposes an unspecified relaxation of this rule.

I do not support such a change as it is contrary to the principle that the losses belong to their respective shareholders. Further as losses are subject to timebar and there is a loss base of $44 billion such a proposal has significant fiscal risk.

I also note that in the HWI paper[3] the HWIs themselves had losses of $60 m and the companies they control losses of over $3 billion so even our most successful business people are not extinguishing their losses over a lifecycle.

However if there was a need to revisit this principle I would suggest that the 66% shareholding similarity offset rule, the small R&D intensive firm cash out and the ability of loss to be carried forward in perpetuity – or even the connection with shareholding generally – be reconsidered.

Digital economy

The issue outlined by officials is one that has significant public concern; foreign companies being able to earn profits from New Zealand and not pay any tax in New Zealand on the profits.

This arises from a provision in our double tax agreements that preclude taxation unless there is a taxable presence – permanent establishment – in the country where profits are earned. Such a provision is an international norm and equally benefits New Zealanders selling offshore.

As discussed by officials this is an issue that affects both goods and services. However it is important to note that the proposed solutions only apply to a particular type of services; ones where the is value created in the source country ie New Zealand.

The broader issue of goods and other services which previously may have required a physical presence to supply the New Zealand market but now don't; is outside the scope of the potential solutions. Such goods and services, however, are now or will be subject to GST.

[3] https://taxworkinggroup.govt.nz/resources/information-release-high-wealth-individuals-wealth-accumulation-review page 15-17

Ultimately this can lead to a hollowing out of the company tax base with a need to find alternative sources of revenue. As New Zealand collects an above average amount of company tax this will mean it is a greater issue for New Zealand than other countries.

Vacant houses and idle land

I note that these provide different policy issues. The former is empty houses at a time of insufficient shelter for all New Zealanders while the latter is that land may be being used suboptimally. I would suggest there was a stronger case to focus on the empty houses in areas facing housing constraints.

I would also suggest that this issue tends well to analysis as a corrective tax analysis either for behaviour change or revenue which could be recycled into increasing the housing supply. Compliance and administration costs like all corrective taxes would be a key issue.

However I would suggest that such taxes would be better levied by local authorities as targetted rates if they were concerned about the issues in their particular area.

Andrea Black
11 July 2018