Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

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Coversheet: **Closely-held companies follow up**

Background Paper for Session 14 of the Tax Working Group
July 2018

Purpose of paper

This paper follows on from the papers *Dividend Avoidance* and *Closely-held Companies* that were discussed by the Group in Session 6. Those papers highlighted the pressures on the taxation of closely-held companies due to inconsistencies in treatment between companies and individuals arising out of differences between the company and personal tax rates and the taxation of capital gains. This paper discusses some options to address those inconsistencies.

Key points for discussion

Does the Group agree with the Secretariat's conclusions:

- That a capital gains tax mitigates most of the mismatch issues identified.
- That adopting any of the other options to address any tax rate deferral would not be warranted given the size of the tax rate differential and deferral currently.

Which, if any, of the options outlined in the paper does the Group wish to discuss in the Interim Report?

Recommended actions

We recommend that the Group:

a) **indicate** whether it agrees:

   i. That, putting aside alignment of the company and top personal tax rates, a capital gains tax is the single best solution to the problems identified.

   ii. That adopting any of the other options would not be warranted given the size of the tax rate differential and deferral currently.

b) **indicate** which of the options should be discussed in the interim report.

Closely-held Companies Follow up

Discussion Paper for Session 14
of the Tax Working Group

July 2018

Prepared by the Inland Revenue Department and the Treasury

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Executive Summary

This paper follows on from the papers *Dividend Avoidance* and *Closely-held Companies* that were discussed by the Group in session 6. The paper notes that there are pressures on the taxation of closely-held companies due to inconsistencies in treatment between companies and individuals. Those inconsistencies arise from the differences between the company and personal tax rates and the taxation of capital gains. These pressures have led to a number of arrangements to avoid taxation under the imputation system.

The company tax rate was lowered in 2008 and 2011 to encourage non-resident investment in New Zealand. As a consequence, the company tax rate and the personal tax rates are not aligned. Two problems have been identified arising from this difference:

- avoidance of dividend taxation (i.e. the 5% top up on income previously taxed in the company and the full 33% top personal tax rate on capital gains and any other untaxed income earned by the company); and
- the long-term deferral of the top-up (currently 5%) between the company and the top personal tax rate on the dividend.

For domestic businesses there is a case for alignment of the company tax rate with the top personal rate for system consistency/integrity purposes. This is particularly so for closely-held companies that could alternatively be operated directly by the owners and subject directly to personal tax rates.

The Group is considering whether there should be a broad-based tax on capital gains. Such a tax would resolve the avoidance of any tax on the dividend where arrangements involve the sale of shares, but deferral of the top-up would still be possible. If a broad-based capital gains tax is introduced, a question then is whether this remaining gap is of sufficient concern to warrant further measures.

There are other measures that would address deferral of the top-up to the personal tax rate which could either supplement a capital gains tax, or be an alternative for addressing this issue if there is no capital gains tax. The options discussed in the paper are:

- For closely-held companies, directly aligning the company rate with the top personal rate, which could be achieved through reintroducing a modified version of a qualifying company.
- Indirectly aligning rates through making look-through company treatment compulsory for closely-held companies, thereby attributing the company's income to its owners and taxing it at their personal tax rates.
- Taxing investment income of closely-held companies at the top personal tax rate, which would not change the treatment of business income.
- Making loans to shareholders (particularly overdrawn current accounts) taxable as a dividend if the loan is outstanding at the end of the year.

The first and second options were included in the Session 6 paper. They would improve integrity but would create some difficult borderlines, and add to complexity. They would also raise the effective tax rate on New Zealand-owned businesses. This would be particularly problematic if personal tax rates were to rise in the future. We would not recommend these options if the Group considers that it is appropriate to tax New Zealand resident-owned closely-held companies at the company tax rate.

The third option was also raised in the Session 6 paper. Imposing personal tax rates on investment income for closely-held companies would reduce deferrals. However, at current tax rates, the deferrals do not appear significant enough to warrant the complexity of a surtax. Moreover, a surtax on closely-held companies would not be consistent with the decision to continue with a capped rate for portfolio investment entities (PIEs).

The last option, to make loans to shareholders taxable as a dividend if the loan is outstanding at the end of the year, would reduce deferrals arising with current account loans. This issue is already on the Tax Policy Work Programme. There are some technical issues that officials would like to consider in the tax policy work programme process, including Australian experience, before we make a definitive recommendation on this.

In summary, our judgement is that adopting any of these options would not be warranted. From our work in this area, it is clear that, putting aside alignment of the company and top personal tax rates, a capital gains tax is the single best solution to the problems identified.

Questions for the Group:

- Does the Group agree with the Secretariat's conclusions?
- Which, if any, of these options does the Group wish to discuss in the Interim Report?

1. Introduction

1.1 Purpose

1.1.1 The purpose of this paper is to seek guidance from the Group on what issues with respect to the taxation of closely-held companies they would wish to include in the Interim Report.

1.2 Content and scope

1.2.1 The topic was introduced in Session 6 in two papers: *Closely-held Companies* and *Dividend Avoidance*. At that session it was noted that the topics of the taxation of closely-held companies and capital gains were related. It was decided that the topic should be revisited after capital gains taxation had been explored and discussed further.

1.2.2 This paper briefly recapitulates the main issues raised in the previous papers and discusses a number of options in this area, including their relationship to the taxation of capital gains.

1.2.3 This paper is intended to focus discussion on the choice of alternatives for possible inclusion in the Interim Report.

1.2.4 The previous papers contained considerable background material and contextual discussion that is not repeated here. Footnotes provide cross references to the previous papers when they contain relevant discussion.

1.3 The four capitals

1.3.1 Some individuals, especially high-wealth individuals, can hold substantial assets through closely-held companies. The pattern of taxation of income on these assets depends upon the taxes paid by the entities combined with the taxes paid by the individuals when the income is received by them.

1.3.2 The taxation of income 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.

1.3.3 The resulting pattern of taxation can have an important effect on social capital goals by affecting the distribution of taxation. This may be particularly the case when tax planning opportunities are disproportionately available to higher-income individuals.

1.3.4 Financial and physical capital may be affected if tax levels on similar economic situations vary due to the form of the arrangements employed to make the investment. Such variation can affect the efficiency of allocation of investment.

1.4 Terms of reference

1.4.1 The Terms of Reference of the Group explicitly declared out of scope "Increasing any income tax rate or the rate of GST". Options in this paper would increase the rate of tax applied to certain income earned in closely-held companies. However, this is accomplished by more effectively applying existing personal tax rates to that income. That is, some company income is treated as if it were personal income. Arguably this does not contravene the Terms of Reference.

2. Pressures in the current system

2.1.1 The papers identified a number of pressures on the current system that arose from inconsistencies between the taxation of closely-held companies and their shareholder/owners taking into account the effects of the imputation system on income earned and taxed in a company and then distributed to their owners. Inconsistencies can lead to situations where economically similar transactions or arrangements, which differ in form, can be subject to different levels of taxation. The differences lead to either higher or lower levels of tax.[1]

2.1.2 Inconsistencies are undesirable as they can lead to inefficiencies in asset allocation; can encourage inefficient business arrangements purely for tax purposes; and, can open up opportunities for taxpayers to avoid the intended incidence of taxation.

2.1.3 Taxpayers naturally try to benefit from situations where tax levels can be reduced; and to mitigate situations where tax levels are increased. The questions for tax policy are: when are these actions outside the scope of intended policy; and, what measures may be needed to achieve the desired results.

2.1.4 The inconsistencies (described below) are not mistakes. They arise from the fact that different policy priorities apply to company taxation and personal taxation. Sensible policy decisions at each level may, when combined in transactions involving the two levels, lead to end results that are undesirable.

2.2 Misaligned tax rates

2.2.1 The first inconsistency arises from the fact that the company tax rate is lower than the top two personal tax rates.

2.2.2 The company tax rate is 28 per cent. Personal tax rates can be higher; 30 per cent for incomes between $48,000 and $70,000; and, 33 per cent for higher incomes. Accordingly shareholders with sufficient income can reduce their taxes by earning it in a company and delaying its distribution. In principle, when the income is eventually distributed, it is taxed at the shareholder's personal tax rate due to the action of the imputation system. When incomes are large and the deferral lengthy, the reduction in taxes can be significant.

2.2.3 Company tax rates have been set, in part, for reasons of international taxation. Personal tax rates, on the other hand, reflect the desired progressivity of the tax system of the Government. If the rates were aligned, these problems would not arise.

2.2.4 The previous paper identified a number of situations where the tax deferral benefits could arise. These generally arose in circumstances where the income could be considered to be personal in nature, but was earned through a corporate intermediary. The situations included funds invested by the company that could be considered to be personal savings, (either out of

[1] Section 3: Integrity issues in the paper *Closely-held Companies*, pp. 7-8, discussed these issues.

retained earnings or by transfer of personal funds into the company), and personal service income earned through a company.

2.3 Capital gains mismatch

2.3.1 The second inconsistency is that capital gains and certain other forms of income are not taxed directly, but can be effectively taxed when earned in a company and distributed to shareholders as an unimputed dividend.

2.3.2 Thus, capital gains provide an example where the use of a company to earn income can lead to an increase in tax. Currently capital gains are not subject to tax when earned by either a company or an individual. However, if a capital gain is earned by a company and the funds are subsequently distributed to a shareholder as a dividend, the dividend is unimputed and so is subject to full taxation at the personal level. In effect, the underlying capital gain has been made taxable. The following table illustrates the effect.

2.3.3 If 100 of capital gains are earned directly by an individual no tax is paid and net personal income is 100. When the income is earned by a company, again no tax is paid. However, when the income is distributed as a dividend it is unimputed. That is, there are no imputation tax credits available to reduce personal tax on the dividend. Accordingly, tax is paid at the personal tax rate, (assumed to be the top rate of 33 per cent), and net personal income after tax is reduced to 67.

Taxation of capital gain		
	Earned directly	**Earned through company**
Gain in company	n.a	100
Tax in company	n.a	0
Net Income of company	n.a	100
Dividend or gain	100	100
Personal tax	0	33
Net personal income	100	67

2.3.4 The taxation of unimputed dividends was a deliberate policy decision taken to provide a back-stop to company taxation in order to increase the robustness of New Zealand company taxation.[2] Any income including capital gains which is not taxed at the company level is taxed when distributed as a dividend.

2.3.5 With capital gains, however, there is an additional complication because these are taxed if paid as a dividend but not upon the winding up of a company. This can create incentives for firms to wind up rather than pay out capital gains as a dividend.

[2] Section 2 of the paper *Closely-held Companies*, pp. 4-6, discussed these issues.

2.3.6 The capital gains mismatch has been controversial for many years and for some types of closely-held companies capital gain income is not taxed when it is distributed. This is true for Qualifying Companies (where unimputed dividends are not taxed) and for Look-Through Companies, where shareholders are taxed as if they earned company income directly, so distributions are disregarded.

2.4 Dividend avoidance[3]

2.4.1 The third inconsistency arises for those on the top personal tax rate as dividends face a positive tax (the 5 per cent difference between the top personal tax rate of 33 per cent and the 28 per cent company tax rate for imputed dividends; and, the full 33 per cent for unimputed dividends). Value extracted from a company through the sale of shares, on the other hand, is treated as tax exempt capital gains.

2.4.2 The following table illustrates the effect of dividend avoidance. In each case, income of 100 is earned by the company. In the first two columns, tax of 28 is paid. When a dividend is paid, an imputation credit is available to reduce personal tax (that is, the dividend is imputed), so personal tax of 5 is paid (33-28) for net income of 67. However, under dividend avoidance, the funds are extracted without attracting tax and so the entire 72 is received by the shareholder. The effect is even larger if the funds are not taxable in the company. If a dividend is paid, there are no imputation credits, so 33 of personal tax is paid and the shareholder again has net income of 67. But in this case, dividend avoidance means that no tax is ever paid on the income and so net income is the full 100.

Dividend Avoidance				
	Imputed income		**Unimputed income**	
	Dividend taxed	**Dividend avoidance**	**Dividend taxed**	**Dividend avoidance**
Income in company	100	100	100	100
Company tax	28	28	0	0
Dividend	72	72	100	100
Net tax on Dividend	5	0	33	0
Net income	67	72	67	100

2.4.3 The paper on dividend avoidance outlined recent developments in tax planning where taxpayers have undertaken transactions that are intended to avoid the effects of the imputation system. These transactions generally involve a series of steps where some funds are received by a shareholder as capital gains, and so are non-taxable. However, under the arrangement, the business is not sold

[3] Pages 2 and 3 of the paper *Dividend Avoidance* provide background on the topic.

to a third party but remains with the shareholder as the ultimate owner. While a straight-forward transaction of this sort is disallowed by New Zealand's "dividend stripping" rules, more complicated transactions that are intended to avoid the application of the dividend stripping rule have come to light. The Inland Revenue Department has recently released a revenue alert that it considers that certain transactions would be disallowed under the General Anti-Avoidance rule.

2.4.4 The alert would certainly deter the use of such transactions. However, it has not been tested in court and it is in any case undesirable to rely on an anti-avoidance rule to implement policy.

2.4.5 To the extent that dividend avoidance transactions are successful, they substantially modify the impact of the previous two issues. In the case of rate misalignment, the tax deferral is made permanent as the tax-back of the dividend is avoided. Similarly, capital gains and any other income that is untaxed at the company level can be effectively distributed tax-free.

2.4.6 In summary, the current system is faced with considerable pressures for tax planning; which provide risks for revenue loss and the failure to achieve the desired incidence of tax over different income groups. Moreover, if the gap between the personal and company tax rates were to increase in the future, these pressures would be exacerbated.

2.5 Current accounts

2.5.1 A closely related issue has arisen with current accounts. Shareholders in companies, usually ones that are closely-held, can operate current accounts whereby the shareholder can withdraw money or other assets from the company for their personal benefit. This is treated as a loan from the current account and will be reversed if, or when, the shareholder repays the loan. Alternatively, the loan balance can be reduced by treating the reduction as a dividend or, if the shareholder is also an employee, by treating the reduction in the loan as salary. Either of these transactions would affect the top-up from the company tax rate to the personal tax rate.

2.5.2 There is no obligation for a shareholder to clear their overdrawn current account at any particular time. In the case of a low or no-interest loan the Income Tax Act 2007 charges tax to the extent the interest actually charged by the company is less than a market rate. This is achieved by treating the difference as a dividend, or as a fringe benefit if the shareholder is also an employee. If the shareholder decides at a later stage not to repay the loan, it is a dividend at that stage.

2.5.3 The rationale for this approach is that conceptually the net present value of the tax paid on an interest free loan (as described above) with a dividend at a future date is the same as the tax that would have been paid if the loan amount had been treated as a dividend upfront.

2.5.4 There is a concern that current accounts are an area with poor compliance, and that extended deferrals of the top-up taxes can arise in those circumstances. In practice, there are many cases where the taxpayers do not self-assess the tax on interest-free benefit (often due to ignorance of the rules), and sometimes the loan is never repaid and just forgotten by the taxpayer. The owner ends up withdrawing funds from the company to use for personal consumption without ever paying tax at the personal rate.

3. How a capital gains tax mitigates the mismatch issues

3.1.1 The taxation of capital gains eliminates the mismatch for gains that are taxable in the future by taxing such gains whether they are earned in a company or directly by the shareholder.

Dividend avoidance

3.1.2 Taxing capital gains also prevents many forms of dividend avoidance which currently rely on the non-taxation of capital gains as a step in the arrangement. To the extent that arrangements do not take advantage of the non-taxation of capital gains, some technical work to prevent such arrangements could still be required.

3.1.3 The following table illustrates how capital gains taxation deters dividend avoidance by comparing the after-tax income realised when a dividend is paid compared to when shares are sold to realise the income. In each case 100 is earned in the company (assumed to be untaxed and therefore unimputed). In that case, tax of 33 is paid on the dividend for net income of 67. Currently, if the funds are distributed in a dividend avoidance transaction involving a capital gain, no tax is paid and net personal income of 100 is received. But if a capital gains tax is imposed, 33 of tax is paid and net personal income is 67.

Dividend Avoidance and Capital Gains			
		Sale of Shares	
	Dividend	**No capital gains tax**	**Capital gains tax**
Unimputed income in company	100	100	100
Dividend/sale of share	100	100	100
Personal tax	33	0	33
Net income	67	100	67

3.1.4 For capital gains that have accrued prior to the introduction of capital gains taxation, there would be no taxation at the company level. Say the company had an asset that was purchased for 40. Assume it is worth 100 when the taxation of capital gains is introduced. The cost of the asset when it was sold would be 100 because of the transitional relief provided on the introduction of the taxation of capital gains. If it was then sold for that amount, no capital gain would be taxed. Assuming that it was the only asset of the company, the shares of the company are also worth 100 when capital gains taxation is introduced. When the shares are sold for 100 as part of a dividend avoidance arrangement, there would be no taxation of the underlying gain. Accordingly dividend avoidance pressures from pre-existing untaxed capital gains would continue to exist even after capital gains taxation has been introduced. If it was concluded that the gains should be taxed (as they would be under imputation), technical work to prevent such dividend avoidance could still be required.

3.1.5 In summary, capital gains taxation puts the future system into a more consistent balance and will reduce both pressure for, and the possibility of, dividend avoidance schemes for income and capital gains earned in the future. However, pools of untaxed or low-taxed income earned in the past could still benefit from dividend avoidance arrangements, so further development of dividend stripping rules might still be required.

Misaligned tax rates

3.1.6 Taxing capital gains does not address the tax deferral arising when "personal" income is earned in a company and so pays the lower company tax rate on that income. At the time that the current tax rates were established, a judgement was made that the amount of deferral was sufficiently small that explicit rules to prevent it were not necessary. provided that dividend avoidance could be prevented when dividends were distributed, so that the tax benefit was a deferral and not a permanent reduction of tax.

3.1.7 As discussed, dividend avoidance has been a problem currently, but assuming that capital gains are to be taxable, it should be prevented on a forward-going basis. Thus the first question is whether it is the judgment of the Group that the tax benefits arising from deferral of tax due to the lower company tax rate are sufficiently small that special taxation of company income for closely-held companies is unnecessary.

3.1.8 The second question is: what would happen if tax rates were to diverge more in the future, either because of a reduction in the company tax rate or an increase in the top personal tax rate? Would it be appropriate to future-proof the tax system by introducing mechanisms now to provide a more balanced system in the future?

3.1.9 The figures in the table below assume that the taxation of dividends is effective. 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).

3.1.10 The after-tax income realised is compared to the after-tax income arising from direct taxation where the income is earned by the individual and income is taxed at the personal tax rate as it is earned.

3.1.11 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.

Benefit from tax deferral (with effective dividend taxation)				
	No deferral	**10 year deferral**	**20 year deferral**	**30 year deferral**
Current tax rates	0%	2%	5%	7%

3.1.12 As noted there are a number of options that could be used to reduce or eliminate these deferrals. These are discussed in the next section. In theory, these options could be introduced with or without taxation of capital gains. However, given the limited size of the deferral benefits, the Secretariat does not recommend proceeding with any of these options for the reasons outlined in the next section.

4. Possible options

4.1.1 The paper introduced a number of options to address the above issues.

4.1.2 It is not the purpose of this paper to discuss whether New Zealand should introduce taxation of capital gains. However, as noted in the discussion in Session 6, a decision on its general merits to introduce taxation of capital gains would reduce the pressures for dividend avoidance. However, that won't prevent all cases of deferral so the following options could be considered whether or not there is a general capital gains tax, although the significance of the issue would be reduced if there were a general capital gains tax. The options include:

4.2 Option 1: Reintroduce a modified form of qualifying company

4.2.1 The option would apply the top personal tax rates to income earned by a closely-held company. This could be accomplished by reintroducing a broadened definition of a qualifying company (QC), taxed at the top personal tax rate, rather than the company tax rate[4].

4.3 Option 2: Make the LTC regime mandatory

4.3.1 This option would make use of the Look-Through Company (LTC) regime mandatory if a company is closely held and controlled by New Zealand residents. The LTC regime treats income of a company as taxed at the shareholder level directly rather than to the company.

4.4 Option 3: Special surtax on investment income

4.4.1 Delays in the distribution of dividends can allow investment income earned on the retained earnings to be taxed at the 28 per cent company tax rate rather than the top personal tax rate. This would apply if retained earnings are applied to make portfolio investments that could have been made by the shareholder directly, instead of being reinvested in the company business. A surtax on investment income or an excess retention tax could top up the 28 per cent tax rate to effectively impose the top personal tax rate and so eliminate the deferral of tax. A number of ways to implement these taxes are possible. The paper does not explore these approaches in detail. The options were discussed in the earlier paper in Session 6.

4.5 Option 4: Treat overdrawn current accounts as dividends

4.5.1 One way to address the deferral issues with current accounts would be to treat overdrawn current accounts as dividends in certain circumstances. This would be similar to Australia's treatment. Consideration of this option is currently part of a wider dividend project on the Tax Policy Work Programme.

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[4] The LTC and QC regimes are described in the paper taxation of closely-held Companies on page 6.

5. Analysis of options

Options 1 and 2: QC or LTC extension

5.1.1 The most coherent alternatives would be to introduce a special regime that would tax closely-held companies as if the income had been earned directly by shareholders as described under Option 1 or Option 2.

5.1.2 Option 1 and 2 address all of the inconsistencies. To be effective, the treatment would need to be compulsory and extend more broadly to all New Zealand resident-controlled closely-held companies. This would be a substantial broadening from the current limited, discretionary coverage of the LTCs.

5.1.3 While these options are theoretically attractive, the Secretariat does not recommend proceeding with them. The options would apply a higher tax rate to closely-held businesses than other competing businesses. We do not believe that this would be sustainable. It would become more problematic, if over time the gap between the company and top personal tax rates were to widen.

Option 3: Surtax on investment income

5.1.4 Option 3 would reduce misalignment pressures. It does not have the same problematic competitiveness consequences of taxing the business income of closely-held companies at a higher tax rate than other companies. It would also be effective in reducing some of the tax deferrals outlined above.

5.1.5 However, introducing an investment income surtax would add complexity and be inconsistent with the Group's prior decision to maintain the capped tax rate for PIEs. Accordingly, the Secretariat does not recommend it.

Option 4: Current accounts

5.1.6 In Australia, a shareholder loan is treated as a dividend in the year that it is made if it is not repaid by the time the company lodges its income tax return for the year.

5.1.7 We have been advised that these rules, which have been in place for twenty years, work. However, they are complex, and people have tried ways to get around them, which have led to further changes and more complexity. They are not rules that small business owners general try to figure out themselves.

5.1.8 New Zealand used to have a similar approach of treating the outstanding loan as a dividend, but it was subject to the Commissioner's discretion. It was repealed as part of a wider suite of dividend amendments.

5.1.9 This issue is currently on the Tax Policy Work Programme. In principle, the current rules are not wrong in concept. Many of the problematic situations with current accounts arise from inadequate compliance. Accordingly it may be premature to make recommendations in this area.

6. Conclusions

6.1.1 On the basis of the foregoing, the Secretariat believes that taxation of capital gains offers the single best way to relieve pressures in this area. While there are other options to directly address tax deferrals arising from the misalignment of tax rates, they raise problematic issues of competitiveness between closely-held and other businesses or are inconsistent with the decision of the Group to retain the capped tax rate for PIEs. Accordingly, the Secretariat does not recommend them. In the case of shareholder current accounts, as this matter is on the Tax Policy Work Programme it seems premature to make a recommendation.