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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.

Meeting 7 companion note

Further to meeting 6, I have set out some further comments on closely held companies that I think are relevant for considering the issue of underreporting in incorporated vehicles. For these reasons I question officials assumption that underreporting is less of an issue through incorporated vehicles. I am also starting to wonder if below contributes to the lack of desire of small businesses to expand.

While only two (personal expenditure and income splitting) of the four issues directly speak to tax evasion; the other two (interest deductibility and overdrawn current accounts) involve 'beneficial structures' that aren't available to the employed or widely held businesses.

Finally I comment on the effective tax rate paper and in particular tax secrecy and retirement villages.

Closely held companies and underreporting of income

Interest deductibility

Companies are entitled to full deductibility for all interest expense. 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.

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.

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

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. ***It would be good to ask Inland Revenue Investigations for their experiences with this including situations where payments are made to minor children.***

Overdrawn current accounts

While there were concerns expressed last week about the tax system possibly incentivising dividend payments rather than reinvesting in the business; an overdrawn current account represents value received by a shareholder in an untaxed form.

Thus for all these reasons I would expect any findings relating to the unincorporated self employed would apply broadly to the incorporated. It is also starting to make me wonder if above is some of the reasons businesses don't want to expand.

Effective tax rates

Tax secrecy

Inland Revenue has produced this report using averages for industries as a group rather than individually by industry.

Thus a 16% effective tax rate is given for the group comprising Life Insurance, retirement villages and motion picture and sound recording. Industries with substantially different businesses and associated tax rules but as there is a concern with tax secrecy the data of these companies has been combined.

This is the case even though two of the companies in this set *Ryman*[1] and *Summerset*[2] have publicly disclosed they are in a net tax loss position.

Tax secrecy also was an issue when I asked for the HWI report I had previously worked on. That report was not released under the OIA – even with taxpayer information redacted – it was released under a discretion under the secrecy provisions.

This issue will come up later in our work when we discuss the statistics and information we might like Inland Revenue to provide more regularly. Perhaps at that stage it would be good for ***Inland Revenue to outline the constraints it feels it currently has in providing information publicly.***

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[1] Note 4 https://www.rymanhealthcare.co.nz/images/pdfs/Ryman_Annual_Report_2017.pdf
[2] Note 7(d) https://www.summerset.co.nz/assets/Investor-centre/3f535469bd/2017-Annual-Report.pdf

Retirement villages

From my point of view there are three aspects to these companies low or no tax to high accounting income:

1) Large unrealised gains. These are responsible for most of the permanent differences between accounting and tax. This makes sense as their business model is to build, own and 'lease' property. This means though that any extension of taxation of capital income through including realised gains will not increase the tax paid by this sector.

2) 'Lease' payments being provided through the time value of money associated with the no-interest loans or occupancy advances provided by the residents. This time value of money benefit is not captured by the tax system as there is a commitment to repay on leaving on day 1. This gives an equal and opposite deduction.

   However to the extent this no interest loan to the company crowds out an interest deduction; it is broadly tax neutral.

3) Interest payments on loans for building more units is capitalised to the building rather than immediately deducted. However the officials paper shows that this only has an overall tax effect of $50 million.

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