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WEEKLY COMMENT: FRIDAY 15 JULY 2022

1. On 16 March 2022 the government issued the discussion document "Dividend integrity and personal services income attribution" (the "Dividend/PSA DD") inviting submissions on the proposals, which closed on 29 April 2022. The integrity measures are designed to limit the ability of individuals to avoid the top 39% tax rate, or the second-highest 33% tax rate, by diverting their income through entities taxed at a lower rate.

2. The Dividend/PSA DD is tranche one of a series. The second and third tranches will consider trust integrity and company income retention issues and integrity issues with the taxation of portfolio investment income.

3. The Dividend/PSA DD proposes:

   (a) That any sale of shares in a company by the controlling shareholder be treated as giving rise to a dividend to the shareholder to the extent that the company (and its subsidiaries) has retained earnings;

   (b) That companies be required, on a prospective basis, to maintain a record of their available subscribed capital (ASC) and net capital gains in the form of available capital distribution amounts (ACDAs), so that these amounts can be more easily and accurately calculated at the time of any share cancellation or liquidation; and

   (c) That the "80 percent one buyer" test for the personal services attribution rule be removed.

4. Following consultation, officials were instructed to do further work on the proposals due to a number of concerns raised by submitters. The Ministry of Business, Innovation and Employment (MBIE):

   (a) Was concerned that an unintended consequence may be to disincentivise the establishment of and investment in start-ups by founders and investors; and

   (b) Noted that the policy may have high compliance costs for small business around record keeping and reporting of ASC and capital gains.

5. This week I am reviewing the dividend integrity measures as proposed in the Dividend/PSA DD. Next week I will look at the proposals concerning record keeping for ASC and ACDAs and the proposed changes to the personal services income attribution rules.

6. The Dividend/PSA DD states that the integrity measures "would create the potential for a significant amount of income (a large proportion of which is derived by comparatively few families and individuals) to be recharacterised and taxed at the appropriate rate".

7. Two key issues are identified in connection with dividend integrity:

   (a) The sale of shares in a company could permanently eliminate the taxation of retained earnings if the purchaser acquires 100% of the shares using a holding company and makes use of the intercorporate dividend exemption;

   (b) Determining the amount of taxable dividends on liquidation of a company can be highly problematic when no records of available subscribed capital ("ASC") have been maintained.

8. Officials have also argued that the personal services income attribution rule is not currently framed widely enough:

   (a) There is scope to avoid the 39% tax rate regardless of the number of customers, therefore, limiting attribution to situations where at least 80% of the entity's income is derived from services to a single buyer (or associated buyers) is not warranted;

   (b) Limiting attribution to where 80% of an entity's income is derived from services by the working person and their relatives may also not be warranted, and submissions have been invited on reducing this requirement to 50%;

   (c) Submissions have also been invited on the level of the threshold for the substantial business assets test, which is currently the lower of $75,000 or 25% of the entity's income from personal services for the income year.

9. The proposed solutions are:

   (a) That any sale of shares in a company by the controlling shareholder be treated as giving rise to a dividend to the shareholder to the extent that the company and its subsidiaries has retained earnings, with a corresponding increase in the company's ASC;

   (b) To require companies, on a prospective basis, to maintain a record of ASC and net capital gains, similar to the imputation credit accounts currently kept, but with fewer entries;

   (c) To eliminate limiting the attribution of personal services to situations where at least 80% of the entity's personal services income is derived from a single buyer;

   (d) To consider reducing the 80% threshold for income from personal services to 50% to trigger attribution of income; and

   (e) To consider the level at which the threshold for the substantial business assets test should be set.

Possible share sales scenarios to which a dividend re-characterisation should apply

10. Officials consider that dividend re-characterisation rules should apply to all share sales because the effect for the selling shareholder is, generally, the same, and the re-characterisation has the effect of taxing the selling shareholder on retained earnings:

    (a) Scenario 1: In this case, the selling shareholder forms a new company to acquire the shares, so that economic ownership is unchanged, and the new interposed company is able to access retained earnings of the acquired company and distribute them to the shareholder either as a loan repayment or as a share repurchase – in either case, retained earnings of the company sold are distributed to the shareholder free of tax;

    (b) Scenario 2: In this case, the selling shareholder sells to an unassociated holding company, which then extracts the retained earnings of the sold company and distributes them to its shareholder free of tax, while the original shareholder enjoys a capital gain on the sale of the shares, also free of tax;

    (c) Scenario 3: In this case, the selling shareholder sells to an unassociated individual – in this case, while the selling shareholder enjoys a tax-free capital gain on the sale, the purchasing individual is unable to extract the retained earnings from the company without paying tax, as any imputation credits would be forfeited on the sale.

11. Officials argue that while Scenario 3 could potentially have an adverse effect on the purchaser, the seller enjoys a capital gain and, it is the seller at whom the integrity proposals in the discussion document are aimed at. Therefore, the seller should be taxed on the share sales in all three scenarios.

Details of a rule

12. Officials consider that the rule should apply to share sales:

    (a) By shareholders who are NZ resident natural persons, trustees and companies, excluding PIEs, superannuation schemes and group investment funds, and excluding sales of shares by shareholders in listed companies and by portfolio shareholders;

    (b) By a partnership or a limited partnership, treating the partners as if they directly owned and sold the shares in the company;

    (c) In companies that maintain an imputation credit account (“ICA”), meaning shares in NZ resident companies and in Australian resident companies that elect to maintain an ICA;

    (d) By controlling shareholders who own more than 50% of the company, aggregating the ownership interests of shareholders who are associated and other shareholders acting together;

    (e) Of any size – so there is no ability to avoid recharacterization by selling shares in small “drip feed” parcels;

    (f) Made within two years of a previous sale of the company’s shares by the seller, to the same or associated buyers(s), where the seller did not control the company immediately before the current sale, but controlled the company before the earlier sale – an anti-avoidance “look back rule”.

13. Officials consider that duplicating the liquidation approach to determining the taxable dividend will be too complicated in the case of a share sale. It is noted that in a liquidation, the taxable dividend is calculated as a residual amount (to which available imputation credits can be added) after deducting:

    (a) ASC;

    (b) Realised and unrealised capital gains; and

    (c) Accounting retained earnings on foreign portfolio shares to the extent they exceed taxable income under the fair dividend rate ("FDR") regime.

14. Instead, officials consider that the taxable share sale amount should be the selling shareholder's ownership percentage applied to the higher of:

    (a) Grossed up accounting retained earnings (less non-taxable capital gains); and

    (b) Grossed up ICA credit balance.

15. For example, if the selling shareholder sold a 20% ownership interest in a company that had retained earnings of $2,390,000 and an ICA credit balance of $910,000:

    (a) The shareholder's portion of grossed up retained earnings would be:

        (20% x 2,390,000) + (20% x 910,000) = $660,000;

    (b) The shareholder's portion of grossed up ICA credit balance would be:

        (20% x 910,000)/0.28 = $650,000;

    (c) The higher amount of the two is $660,000, which is the deemed gross dividend;

    (d) The deemed net dividend is $660,000 x 0.72 = $475,200:

        (i) If the share sale amount is not less than $475,200, the net deemed dividend would be $475,200, and the gross deemed dividend, would be $660,000; and

        (ii) If the share sale amount is less than $475,200, the entire share sale amount will be the net deemed dividend and gross deemed dividend will include the ICs that are, or could be, attached.

16. The tax payable would be:

    (a) The relevant tax rate applied to the taxable share sale amount;

    (b) Less the allocated ICA balance, which is available to the shareholder as a tax credit.

17. Continuing the example in paragraph 15 above, If the shareholder's tax rate is 39%, and the sale price is not less than the deemed net dividend of $475,200, the tax payable would be:

    (a) $660,000 x 0.39 = $257,400;

    (b) Less the shareholder's share of the ICA balance: $182,000;

    (c) The net tax payable would be $257,400 - $182,000 = $75,400.

18. If the sale price is less than the corresponding net dividend amount, the sale price is the net dividend, which must be grossed up by the ICs that are, or could be, attached, to determine the gross dividend. Continuing the example in paragraphs 15 and 17 above, if the sale price is $403,200:

    The deemed gross dividend will be $403,200/0.72 = $560,000.

19. In that case, the tax payable would be:

    (a) ($403,200/0.72) x 0.39 = $218,400;

    (b) Less the ICs that could be attached – being the lower of:

        (i) ($560,000 - $403,200) = $156,800; and

        (ii) The shareholder's portion of the company's ICA balance at the time of sale: $182,000;

    (c) The net tax payable would be $218,400 - $156,800 = $61,600.

20. Since the retained earnings out of which the net deemed dividend is paid remain in the company, the seller is treated as if the net dividend was immediately returned to the company as ASC. Therefore, the ASC balance of the company is increased by the deemed net dividend.

21. Continuing the example in paragraphs 15 and 17 and 18 above, the ASC of the company is deemed to be increased by:

    (a) $475,200, which is the deemed net dividend, if the selling price is not less than $475,200; and

    (b) The amount of the selling price, if the selling price is less than $475,200.

22. If the ICA balance is not forfeited on sale, the ICA is debited by the amount of the ICs included in the deemed gross dividend:

    (a) If the price is not less than $475,200, the debit to the ICA will be the shareholder's portion of the company's ICA balance at the time of sale: $182,000; and

    (b) If the price is less than $475,200, the debit to the ICA will be the lower of:

        (i) The maximum ICs that could be attached to the deemed net dividend; and

        (ii) $182,000.

23. The only effect on the buyer is that the buyer benefits from the increased ASC in the company.

24. Officials consider that the deemed dividend should not be limited to the actual gain on sale, because that would effectively allow a deduction for a capital loss. If the selling price is less than the retained earnings, it would mean that some other part of the business has depreciated. Officials consider that the deemed dividend should be based on the retained earnings and any reduction in the value of other assets should not be taken into account.

Applying the rule to share sales by companies

25. Officials consider that if the rule did not apply to companies, a holding comp any structure could result in avoiding a deemed dividend arising. For example:

    (a) A holding company with no ICs could sell an operating company for a capital gain;

    (b) If the shares in the holding company were subsequently sold, no deemed dividend would arise due there being no ICs and no non-capital gain retained earnings;

    (c) If the holding company is subject to the rule, a deemed dividend would arise upon sale of the operating company and the ICs would be transferred to the holding company;

    (d) If the shares in the holding company were subsequently sold, the ICs would result in a deemed dividend.

26. If shares of a holding company of a corporate group (i.e. at least 50% common ownership) are sold:

    (a) The percentage ownership of each subsidiary company should be applied to the ICA credit balance (positive amount) or debit balance (negative amount) of the company, and the total of these sums gives the ICA credit balance for the group;

    (b) If the holding company has consolidated its accounting earnings with its subsidiaries, this would reflect the retained earnings of the group (without having to look through to each underlying company);

    (c) The holding company would have an ASC adjustment of the entire net dividend amount deemed to have been derived by the shareholder;

    (d) For all companies that contributed to the calculation of the deemed dividend amount because they had retained earnings or a non-zero ICA balance, their ASC would be adjusted by the net dividend paid from their own retained earnings or grossed-up ICA, plus any amounts deemed on-paid by subsidiaries;

    (e) An alternative suggested approach to ASC adjustments would be to take the total deemed dividend amount, and pro-rate it among contributing companies in proportion to their respective ICA balances or retained earnings (with parents of subsidiaries also including their subsidiaries' amounts).

Selling shares in a company to another company controlled by the same shareholder

27. If shares in one controlled company are sold to another controlled company that also has retained earnings or an ICA balance, the amount received by the shareholder potentially substitutes:

    (a) For a dividend paid in respect of the retained earnings of the company that is sold; plus

    (b) For a dividend paid by the purchaser company to the extent the shares are paid for out of the purchasing company's retained earnings.

28. The suggested approach is to:

(a) Take into consideration only cash or equivalent paid by the purchasing company – i.e. ignoring consideration paid in the form of shares in the purchasing company – for example, say a purchasing company pays $1,940,000 for ASC of $1m plus retained earnings of $940,000 in a target company;

(b) Follow United States legislation by treating the amount received as paid out of the retained earnings of the purchasing company, calculated by grossing up the ICA balance or retained earnings of the purchasing company (or group) – for example, say the purchaser company has ICs of $560,000, the grossed up value of which is $2m, giving a net deemed dividend of $1,440,000;

(c) Treat any remaining amount received by the shareholder for the shares, after deducting the deemed dividend from the purchasing company, as reflecting a deemed dividend from the target company – for example, as the purchaser company's deemed dividend is $1,440,000 and less than the price paid of $1,940,000, there is a potential net deemed dividend from the target company of $500,000, assuming the target company's grossed up ICs result in a possible net dividend of more than $500,000;

(d) Require the shareholder to pay tax of $296,389, calculated as follows:

   (i) Gross deemed dividend from the purchaser company of $2m @ 39% = $780,000, less the ICs of the purchaser company of $560,000 = tax to pay of $220,000; plus

   (ii) Gross deemed dividend from the target company of $500,000/.72 = $694,444 @ 39% = $270,833, less the ICs attached of $194,444 = tax to pay of $76,389;

   (iii) Debit the ICA of purchaser by the ICs used of $560,000, and the ICA of the target company by $194,444;

(e) Increase the ASC of the target company, immediately before the acquisition by the purchasing company, by the amount of the deemed dividend attributed to the target company – continuing the above example, the target company's ASC would increase by $500,000;

(f) Increase the ASC of the purchasing company by the lesser of the market value of the shares it acquired in the target company and the ASC of the target company – for example, if the target company's ASC before the share sale was $1m, the combined ASC including the increase following the share sale of $500,000, would be $1.5m, which is less than the market value of the shares acquired for $1,940,000, therefore, the ASC of the purchaser company increases by $1.5m;

(g) Make no ASC adjustment in the purchasing company reflecting the deemed dividend because the money has been paid out of the purchasing company and there is no deemed recontribution to the purchasing company.

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