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WEEKLY COMMENT: FRIDAY 22 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. As noted last week, officials have been instructed to further work on the proposals due to the concerns raised by submitters. Nevertheless, they are worth reviewing and this week I look at the proposals concerning record keeping for ASC and ACDAs and the proposed changes to the personal services income attribution rules.

Available subscribed capital (ASC): problems with current practice

3. Officials have set out a number of concerns in connection with correctly determining a company's ASC and available capital distribution amount (ACDA) when capital is repurchased:

   (a) The tax rules ion sections CD 43 and CD 44 are complex;

   (b) The tax rules change from time to time, meaning that the appropriate treatment of a transaction depends on the year in which it takes place;

   (c) Many years may pass between the occurrence of transactions giving rise to changes in ASC and ACDA and the time when a distribution is made for which the amounts of ASC and ACDA are relevant;

   (d) There is no explicit requirement for a company to keep records in relation to ASC and ACDA:

      (i) Section 22 of the Tax Administration Act 1994 ("the TAA") does not apply because these amounts are not required for the calculation of the company's own income or deductions;

      (ii) Section 22AAB(2) of the TAA potentially requires records to be kept when a person liable to pay RWT has to determine the dividend portion of a share repurchase, however, the section is aimed at ascertaining information about a person who has received a dividend, rather than determining whether a distribution is a dividend in the first place;

(e) As noted in draft operational statement ED 0239 released in December 2021, a company without adequate records to substantiate its ASC and ACDA will effectively lose these amounts as it will not be able to satisfy the burden of proof that a distribution is not a dividend:

(i) In cases where the taxpayer cannot provide sufficient evidence to support their ASC calculation, the Commissioner may dispute the tax position on the basis that the distribution is a dividend;

(ii) The onus of proof is on the taxpayer to show that the basis for their self-assessment is correct;

(iii) While s 22 of the TAA requires taxpayers to keep sufficient records for 7 years, the calculation of ASC can require consideration of circumstances that happened more than 7 years ago, and the taxpayer will need to keep sufficient records to substantiate their tax position.

Policy options for ASC and ACDA accounts

4. Officials have suggested that a company would be required to keep sufficient records the enable the ready ascertainment by the Commissioner of the company's ASC and ACDA:

(a) The records would need to be kept for the life of the company;

(b) The record keeping requirement would be optional, with companies that elect not to comply not being entitled to a credit to their ASC or ACDAs for the relevant years.

Memorandum accounts reported to Inland Revenue annually

5. A company's ASC and ACDA tracking accounts would be a running total, with each year's closing balance forming the opening balance for the following year.

6. One possible approach for tracking accounts for ASC and ACDA would be to require taxpayers to submit these accounts to Inland Revenue on an annual basis:

(a) This would serve as a prompt to taxpayers to maintain records and provide Inland Revenue with information on a contemporaneous basis;

(b) Failure to submit a tracking account by the due date would mean the taxpayer would require the Commissioner's approval to later increase the account balance, with a hard time limit (5 years has been suggested);

(c) The purpose of the return is to assist taxpayer compliance, rather than place an onus on the Commissioner to audit the return, therefore, there would be no time limit on the Commissioner's ability to challenge the returns;

(d) Practically, challenges would be expected to be made within a short period of entries being made;

(e) In any case, the time bar would operate in relation to tax positions taken by shareholders from the time when they receive distributions of ASC and ACDA;

(f) Compliance with maintaining tracking accounts would be optional and companies that choose not to maintain accounts would have no ASC or ACDA.

7. An alternative approach would be to require taxpayers to maintain their own tracking accounts and to only provide them (along with supporting records) to Inland Revenue when the information is specifically requested, such as in the case of an audit:

   (a) There would be reduced compliance and administration costs;

   (b) There would be a reduced incentive for businesses to maintain accounts, however, if they choose not to maintain accounts they would have no ASC or ACDAs.

Transitional issues

8. Officials propose that any changes to the rules relating to ASC and ACDA tracking accounts should only take effect for transactions occurring after the law is enacted:

   (a) Requiring all existing companies to undertake retrospective calculations would be onerous;

   (b) To the extent that a company's ASC and ACDA figures rely on transactions occurring before the commencement of the new rules, the current law would continue to apply: the company would have the onus of proof at the time the accounts become relevant – i.e. when shares are repurchased or liquidating distributions are made to shareholders.

9. Officials are undecided and have requested submissions on the order in which ASC and ACDA is used:

   (a) Debiting the new tracking accounts would be well documented; whereas

   (b) Debiting historic ASC would support the gradual elimination of such ASC.

Personal services income attribution

10. The attribution rule, contained in sections GB 27 to GB 29, prevents an individual avoiding the top personal tax rate by diverting income to an associated entity when certain threshold tests are met:

    (a) The 80 percent one buyer rule: at least 80 percent of the associated entity's income from personal services in the year comes from the supply of services to a single buyer and persons associated with the buyer;

    (b) The 80 percent one natural person supplier rule: At least 80 percent of the associated entity's income from personal services in the year comes from services supplied by the working person and relatives of the working person;

    (c) Substantial business assets (meaning depreciable property that, at the end of the associated entity's corresponding income year, has a total cost of more than either $75,000 or 25 percent of the associated entity's total income from services for the year) are not a necessary part of the business structure used to derive the entity's income from personal services;

    (d) Net income of working person test: the attribution rule applies only if the working person's net income for the year exceeds $70,000.

11. Officials are concerned that taxpayers on the top personal tax rate of 39% will use trusts and companies to obtain a lower tax rate on what is in fact personal services income.

Therefore, they consider that the fundamental rationale and design of the personal services attribution rule should be shifted from its original purpose of capturing employment like situations to apply more broadly.

12. In particular, it is noted that the single customer rule may not be appropriate, because taxpayers providing services to multiple customers could just as easily use an entity as a conduit for income-earning activity.

13. While the Supreme Court decision in *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95 is helpful in combating tax avoidance, officials prefer to have a specific "black letter" rule to deal with personal services, rather than having to rely on the general anti-avoidance rule.

14. The proposals put forward are as follows:

    (a) The 80 percent one buyer rule be removed altogether – meaning that the attribution rule will not be restricted to situations where there is only a single buyer or associated buyers;

    (b) The threshold level for the existing 80 percent one natural person supplier rule be reduced to 50 percent – meaning that the attribution rule will apply if personal services supplied by a natural person plus relatives account for 50 percent of the associated entity's income from personal services in the year;

    (c) The substantial business assets threshold of $75,000 is too low:

        (i) Option one: increase the threshold to the lower of $200,000 or 25% of the associated entity's income from personal services, excluding the cost of passenger or luxury vehicles unless the entity's business is a transportation business;

        (ii) Option two: increase the threshold to the lower of $150,000 or 25% of the associated entity's income from personal services, excluding the cost of passenger or luxury vehicles unless the entity's business is a transportation business;

    (d) The $70,000 threshold will continue to apply to the net income of working person test, as the marginal tax rate applying to income over $70,000 is 33 percent, which is 5 percent higher than the company tax rate of 28 percent.

15. The change in the substantial business assets threshold will not affect taxpayers whose business assets cost more than 25 percent of their income – meaning that the effect of increasing the threshold over $75,000 will only apply where income from personal services exceeds $300,000 per annum.

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