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Dear Paul,

Dividend integrity and person services income attribution – discussion document

CPA Australia is Australia's leading professional accounting body and one of the largest in the world. We represent the diverse interests of more than 170,000 members in over 100 countries and regions, including over 2,700 members in New Zealand. We make this submission on behalf of our members and in the broader public interest.

The Government's **Dividend integrity and person services income attribution** discussion paper (the Discussion Paper) proposes the introduction of dividend integrity and income attribution measures to limit the ability of individuals to avoid the top 39 per cent rate (or the second-highest personal income tax rate of 33 per cent) by diverting their income through entities taxed at a lower rate.

We appreciate the opportunity to have spoken with Inland Revenue and Treasury on 8 April to better understand the Government's intention behind the proposed reforms and the practical challenges for Inland Revenue in applying the existing general anti-avoidance rules (GAAR). However, we maintain our view that the proposed changes go well beyond merely targeting individuals with income (or potential income) levels at the higher tax brackets. The proposed measures impose high compliance costs with significant tax consequences for non-adherence and introduce tax distortions into the economic decision-making of corporate business entities.

We do not support the proposed tax rules due to their complexity and widespread impact, in particular:

- The high likelihood that capital gains will be inadvertently subject to tax where taxpayers do not have satisfactory evidence of retained earnings leading to over-taxation
- The imposition of significant advisory and compliance costs on all small business owners while ostensibly seeking to target only a small group of higher wealth individuals with associated entities.
- The proposed calculations to determine the amount of the deemed dividend are extremely complex and we anticipate there will be a number of issues identified when the rules are put into practice
- The potential challenges for businesses and their tax agents, particularly those who are not qualified accountants, to apply the new rules correctly with significant tax costs if not set up, maintained and enforced properly
- The broad proposed scope with a lack of de minimis thresholds or simplified rules
- The limited digital capability of many New Zealand small businesses, thereby creating barriers to accessing the potential benefits of accounting software-driven efficiencies and improved record keeping upon which the proposals depend for effective implementation

- The repurposing of the personal services income (PSI) rules to apply across the gamut of small commercial services businesses, depriving the businesses of profit and the opportunity to retain earnings for business growth
- The continuous limited efforts by Inland Revenue to utilise the GAAR, alternative intervention actions and administrative guidance to influence taxpayer behaviour before seeking significant, complex and disruptive changes to the tax system.

More generally, the Discussion Paper refers to the tensions created in New Zealand due to the absence of a general tax on capital gains. As the Government's proposals increasingly seek to address tax arbitrage by introducing complex and piecemeal measures that distort economic decision making and reduce productivity, we believe that a capital gains tax may be preferable to the current approach.

We also observe that the much-lauded Generic Tax Policy Process (GTPP) is being truncated and condensed to the detriment of New Zealanders. The GTPP epitomises the strength of the tax policy due diligence process in New Zealand and its value lies in the consultative and deliberative manner in which policy is developed to maximise effectiveness and minimise unintended consequences. For such significant proposals, we are concerned that the limited opportunity to consider and test the changes will result in overly complex, very costly and distortionary changes being introduced with limited long-term benefit to the revenue.

Our responses to the questions for submitters in the Discussion Paper are contained in the Attachment.

If you have any queries about this submission, contact Rick Jones, Country Head, New Zealand on +64 21 190 1039 or **rick.jones@cpaaustralia.com.au** or Elinor Kasapidis, Senior Manager Tax Policy on +61 466 675 194 or **elinor.kasapidis@cpaaustralia.com.au**.

Yours sincerely,

Dr Gary Pflugrath
Executive General Manager
Policy and Advocacy

Mr Rick Jones
Country Head
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Attachment

Chapter 3: Proposal to tax a deemed dividend portion of proceeds from selling shares

Is deeming a dividend to arise when shares are sold (while the company has retained earnings) an appropriate policy outcome?

While framed in the context of addressing tax avoidance by higher-income individuals, the deemed dividend proposal generally seeks to more clearly separate capital gains from retained earnings, to ensure that income tax is paid on the latter while maintaining the tax-free status of the former. Currently, the GAAR are available to address dividend stripping cases.

From the perspective of tax system design and ease of tax administration for Inland Revenue, we recognise the rationale behind the proposal to ensure that the full tax base is properly captured. However, we believe that the proposed approach will be costly and unfair in practice.

The proposed mechanics of the deemed dividend rules are exceptionally complicated in their current form. Feedback from our members suggests that the quality, or even existence, of the documentation required to properly establish and maintain records of retained earnings using accounting concepts, imputation credit account (ICA), available subscribed capital (ASC) and/or available capital distribution amounts (ACDA) will be highly variable, particularly for smaller businesses. The Discussion Paper acknowledges these issues in Chapter 4 and the Government should be mindful of the reality of current business practices and the likely prospect of incorrect taxation due to complexity and the lack of historical records.

The scope of the proposed rule is also very broad, capturing small businesses in existence for decades and requiring detailed accounting records to ensure capital gains are properly quarantined. It is likely that capital gains will be inadvertently subject to tax where taxpayers do not have satisfactory evidence of retained earnings, leading to over-taxation.

Should the scope of the proposed recharacterisation rule cover all of scenarios A, B, or C, or only one or two of these scenarios?

We support the scope of the proposed recharacterisation rule being limited to scenario A. The Discussion Paper is focused on the risks arising from transactions between associated entities, so the tax measures should target this particular issue rather than seek to capture all sales of New Zealand businesses.

Scenarios B and C will capture the sale of shares to unrelated companies and individuals. This will impose significant advisory and compliance costs on all small business owners while ostensibly seeking to target only a small group of higher wealth individuals with associated entities.

Is limiting the scope of the proposed recharacterisation rule to sales of shares by a controlling shareholder appropriate, or do you think this is too broad or too limited?

As per our response to the previous question, the limitation of the recharacterisation rule to controlling shareholders is appropriate given the nature of the issue the Government seeks to address.

Is the conceptual basis for quantifying the deemed dividend (that is, undistributed income, not including untaxed capital gains) appropriate?

While the conceptual basis of the proposal may appear simple, the proposed calculations to determine the amount of the deemed dividend are extremely complex. The intention to couple these rules with further complexity by requiring adjustment and monitoring of the ICA and ASC is impractical and inefficient. There will inevitably be increased compliance costs, in particular for smaller businesses.

Whether by design or by default, the current tax proposal will impact a very large group of economically important taxpayers (i.e., small businesses) with limited evidence that they all need to be subject to such complicated tax measures. We note that in prior years, tax administration policy was committed to simplification for small and medium enterprises (SMEs). This proposal stands in contrast to this philosophy by introducing concepts and approaches that introduce complexity and cost.

Given the breadth of affected taxpayers, we suggest that the Inland Revenue first undertake and publish a regulatory impact analysis that also considers existing and alternative options such as the enhanced enforcement of the GAAR and the more active use of Revenue Alerts. This should include estimates of the revenue at risk, the revenue impact of the proposed changes, the affected population and the potential revenue gain from over-taxation due to the deeming rules taxing all but the most evidenced and contemporaneously reported capital gain amounts.

What do you see as the advantages and disadvantages of the suggested dividend quantification approaches (grossed-up ICA, retained earnings, or a combination of the two), and which of these approaches do you prefer? Is there an alternative approach you would suggest?

From an accounting perspective, there may be some advantage from improved record-keeping for liquidators in determining the equity component/share capital of a business. However, most businesses never find themselves in a situation of insolvency, thereby reducing the potential benefit of imposing such requirements on all corporate entities.

The primary disadvantage of the suggested dividend quantification approaches is the complexity of the calculations. Many SMEs have been trading for years and finding historical financial accounts and information can be difficult. As their accounts are generally not required to be audited, accounts and records for SMEs may not be maintained with the same rigour and detail as larger companies. Furthermore, small businesses are quite mobile with their choice of advisor, meaning changes in tax agents/advisors can create challenges in the continuity of documentation.

Poor historical accounting practices can result in small businesses paying more tax than they correctly should when:

- the taxpayer can't prove their ASC/ACDA – the default result is that all of the proceeds are treated as retained earnings, deemed a dividend and taxed, or
- accounts can only be partially reconstructed – the balance of the proceeds that can't be shown to be capital gains are treated as retained earnings, deemed a dividend and taxed, even when in actuality that portion should have been recognised as capital gains.

As an example, in Australia a temporary **loss carry back offset** was introduced which required taxpayers to ascertain their franking account balances in order to claim the amount. Our members in Australia reported that there were significant challenges for small businesses and their tax agents to review these accounts to properly ascertain the correct franking account balance, and the ATO undertook significant work to prepare guidance, online tools, forms and education materials to assist advisors and businesses to properly apply the rules.

This experience highlighted the need for the tax administration to invest in and properly manage the implementation of a significant and complex change. It also evidenced the challenges for small businesses to be able to comply, especially when there had been limited prior awareness of the need to accurately and contemporaneously maintain such records.

Given the complexity and substantial tax consequences of an inability to properly ascertain the grossed-up ICA or retained earnings, the need for education and support from the Inland Revenue is even more critical.

Do you agree with the proposed approach (outlined in Example 3) for calculating dividends and ASC adjustments for corporate groups?

The challenge in evaluating the proposed approach is that specific issues with the calculation are usually identified during implementation, rather than in the design phase. Due to the range of potential permutations and combinations of the more simplistic examples provided in the Discussion Paper, it is highly likely that conceptual and practical problems will be encountered as the rules take effect. We recommend that Inland Revenue continue to engage with advisors and businesses to remedy any deficiencies arising during implementation in a timely manner.

We also hold concerns that some tax agents, particularly those who are not professional accountants, may require substantial support from Inland Revenue to ensure that they are correctly applying the rules. Even further support would be needed for businesses that seek to manage their taxes themselves. We recommend that simplified approaches and de minimus thresholds be considered to better confine the impact to targeted taxpayers and reduce the impact on small business.

Is the approach outlined in Example 4 for a sale of one controlled company to another (existing) controlled company (potentially generating a deemed dividend from both companies) correct conceptually?

As per our response to the previous question.

Chapter 5 – ASC and ACDA tracking accounts – Policy options

Whether the proposed transitional rule is appropriate?

We agree that the transitional issue identified in the Discussion Paper, in relation to a lack of contemporaneous accounts and the difficulty in retrospectively calculating ASC and ACDAs, cannot be underestimated. As is acknowledged, some businesses may never be able to properly establish their exact ASC and ACDA and, depending on the scope of the rule, may ultimately be taxed on capital gains. We seek that Inland Revenue takes a practical and reasonable approach when reviewing transactions in the coming years, and some form of assurance from the Commissioner about their compliance approach would help advisors and businesses to adapt.

In terms of transactions occurring after the law is enacted, the proposal appears to assume that businesses and their advisors will properly understand their obligations and establish the relevant accounts and records from that date. We expect that a period of at least 12 months will be needed to:

- prepare Inland Revenue guidance, support products and education sessions for advisors and businesses
- refresh or build advisors' expertise and proficiency in this area
- establish proper record-keeping processes in businesses and closely held groups
- update software products to include and promote this functionality.

Therefore, we recommend that Inland Revenue be provided with the discretion to adopt a tailored approach to implementation, recognising the high compliance burden and tax costs associated with these changes. We also consider digital service providers (DSPs) to be critical to the implementation of the proposed changes, as they will support the transition and help maintain the integrity of records into the future.

However, the information entered into the software needs to be correct, and there is considerable cost associated with the collation and maintenance of this data and associated records. To reduce the overall cost of the proposal, we suggest that the Government consider introducing a de minimis threshold or simplified rules for small businesses.

Whether the Commissioner should be able to reopen a return and on what basis?

We do not support annual reporting to Inland Revenue, but if progressed, we do not agree with an unlimited period of review being made available to the Commissioner.

Given that the ASC and ACDAs become relevant only upon sale/liquidation of the company and there is a taxpayer incentive to maintain accurate records due to the high tax cost of failing to do so, the case for mandatory reporting and providing the Commissioner with an associated unlimited period of review (i.e., Option 1) is unclear.

Where the concern is that the Commissioner will be forced to accept reported ASC and ACDA amounts after the period of review has elapsed, Option 2 provides a more pragmatic solution where the onus is on the taxpayer to maintain records and Inland Revenue is able to consider these as part of the review of the sale transaction. This second approach is similar to that taken for capital gains tax (CGT) in Australia where historical records are required to substantiate the cost base of CGT assets.

Whether the proposal strikes an appropriate balance between compliance costs and tax integrity?

As indicated in our previous responses, we do not believe the proposal strikes an appropriate balance between compliance costs and tax integrity. There is limited data in the Discussion Paper to assess the potential impacts, however, we expect that all businesses will experience increased compliance costs and, of greater concern, there is the real likelihood of improper taxation of capital gains due to weaknesses in many businesses' record-keeping processes. We believe that these costs will outweigh the expected benefit – given that paragraph 1.11 of the Discussion Paper suggests that the Government's concerns are centred on the behaviour of 350 high wealth individuals, but the proposed changes will potentially affect hundreds of thousands of New Zealand businesses and their owners.

At a practical level, businesses who do not use an agent are unlikely to be able to apply the rules properly and we reiterate the importance of ensuring that tax agents and advisors are properly qualified and competent to perform these services given the potential tax costs if done incorrectly. The proposal that a company will be deemed to have their ASC and ACDA to be zero if not reported to Inland Revenue on a timely basis is also extremely punitive and highly disproportionate to the risk sought to be addressed by the Government.

In the future, accounting software will likely reduce the costs and inefficiencies as records are maintained contemporaneously and can be transferred between different tax agents and different software products. However, CPA Australia's **Asia-Pacific Small Business Survey** consistently finds that the current digital capability of New Zealand businesses lags behind the rest of the Asia-Pacific (with the exception of Australia) and that there is limited appetite for investment in technology, particularly for compliance obligations rather than business growth.

The Government should therefore be mindful of the current capacity of New Zealand businesses to absorb greater compliance costs, particularly as they emerge from the events of the past two years. It is important to understand that many businesses are not currently in a position to transform their accounting systems or establish and maintain detailed records for far-off events.

Whether the ASC and ACDA memorandum accounts should be reported in annual returns?

As per our earlier response, we do not support a requirement to report annually to Inland Revenue. The proposed design creates a very strong incentive for the taxpayer to keep contemporaneous records, because if they are unable to do so, the entire sale proceeds including unsubstantiated capital gains will be subject to tax.

Chapter 7 –Personal services income attribution – Proposal

Fundamentally, we do not support the repurposing of the PSI rules to dictate the commercial decisions of New Zealand services businesses. The PSI attribution rule was intended to prevent the recharacterisation of what is, essentially, employment income.

Corporate structures are chosen for a wide variety of non-tax related reasons, and we are concerned that the proposed changes will significantly diminish the economic choices and growth prospects of many businesses. There are a multitude of reasons why companies retain their earnings, including setting aside capital for future growth and investment, to fund business acquisitions, to hire staff or to take risks.

In Australia, the PSI rules are specifically designed to carve out personal services businesses (PSBs) from the PSI regime in recognition of their different economic nature. Anti-avoidance provisions remain available to the ATO to address any mischief in relation to PSBs.

The New Zealand proposal stands in stark contrast to the Australian design by seeking to actively capture businesses under the PSI regime and to remove the safeguards that protect businesses from tax rules restricting their economic choices. In combination, the proposed changes to the PSI test suggest that the majority of small personal services businesses will be required to attribute income to the working person, without regard to the clear economic benefits of corporate structures. Net income will be taxed through the working person at individual tax rates, leaving nothing available to the business to improve the balance sheet.

For start-ups and new businesses in particular, this can significantly impede access to capital, introduce cash flow difficulties and reduce growth prospects. It is also costly, inefficient and contrary to the purpose of corporate entities to expect balance sheets to be supported by injected capital funded from post-tax income of the individual. Such policies begin to significantly distort the functionality of a company, with tax rules effectively removing the prospect of business profit and eliminating the economic benefits of retained earnings.

In our view, the Government should be supporting small business growth and encouraging entrepreneurship rather than demanding businesses retain no earnings so that income can be taxed at higher rates. While this may provide a short-term boost to government revenues, in the long run it will impede business growth and entrepreneurship in New Zealand.

If the Government is seeking to ensure that working persons report an appropriate level of income for the provision of their personal services to an associated entity (i.e., remuneration for their labour), then consideration should instead be given to alternatives such as the introduction of a domestic transfer pricing regime[1]. The administrative approach taken by the ATO in Australia has been to issue **PCG 2021/4 Allocation of professional firm profits - ATO compliance approach**. This Practical Compliance Guideline explains the ATO's approach to assessing the risk that profit allocation arrangements in professional services firms trigger the Australian general anti-avoidance rules, known as Part IVA, and the likelihood of a review. We believe that the decision in *Penny and Hooper v Commissioner of Inland Revenue* [2011] NZSC 95 provides Inland Revenue with the basis to manage the risks described in the Discussion Paper, including the use of market rates, by applying the existing GAAR, rather than expanding the PSI regime to all personal services businesses.

We also note that should the deemed dividend proposal be progressed, the PSI proposal becomes unnecessary as any retained earnings not otherwise distributed will be taxed in the hands of the controlling shareholder/working person at individual tax rates upon sale of the business.

Do you agree with the proposed removal of the "80 percent one buyer" test? Why/why not?

The removal of this test will expose a significant number of personal services businesses to the PSI regime. The Discussion Paper does not provide data on the number of potentially affected businesses, nor the expected increase in government revenue.

The Government is proposing that any business – regardless of whether they have one, or one hundred, buyers – will fall under the PSI rules, disregarding the fact that the buyer test can be seen as a proxy for the level of commerciality. A higher number of buyers indicates the business is more likely to carry higher levels of commercial and legal liability risks or hold more valuable business assets, such as client lists or long-term contracts for example.

We are not sufficiently convinced of the economic and policy basis for the proposal, except to divert income from the company to the working person with the result that commercial businesses will be treated as if they hold no

[1] That is, entities would be required to remunerate working persons at market wages to ensure that transactions between related parties remain at arm's length and removing the ability to shield income earned through the provision of labour.

economic value except for the services provided by the working person, merely so that a higher tax rate can be applied.

This conceptual approach does not acknowledge the risks borne by the corporate entity, nor the life cycle stage of the business and presumes that such a structure provides no commercial or economic purpose or benefit. We do not believe that this is the correct economic characterisation of such businesses, and consequently do not agree with the proposed change.

Do you agree with the suggested decrease in the threshold for the "80 percent one natural person supplier" test from 80 percent to 50 percent? Why/why not? Can you foresee any problems arising from the suggested change?

This proposed change further expands the captured taxpayer population to include the many small businesses with a part-time staff. Again, this test can be viewed as a proxy for the intensity of labour provided by the working person. A lower percentage indicates that business income is less likely to be solely generated by the working person, and therefore should not be attributed as employment-type income.

A reduction in the threshold to 50 per cent again disregards the economic value generated by other natural persons participating in the business and significantly constrains the ability of the business to increase its value. We therefore do not agree with the suggested decrease in the threshold from 80 percent to 50 percent.

Are the suggested thresholds for the substantial business assets test appropriate? Why/why not?

Further to our earlier comments on arm's length remuneration, if the issue is the use of corporate structures to reduce an individual's tax liabilities and the proposed changes to the one buyer and natural person supplier tests broaden the application of the PSI rules to virtually all personal services businesses, we question why businesses with a higher asset intensity should be entirely exempt.

In the interests of equity, we suggest that any policy changes affecting remuneration or income attribution apply to all individuals who provide their labour to a related entity, regardless of their level of assets. This ensures that all individuals operating their business through such a structure are treated equitably under the tax laws and that certain taxpayers are not discriminated against simply because of the industry in which they operate.

Which of options one and two do you consider to be preferable? Is there another option that you think would be better than either of the thresholds suggested in this chapter?

Per our previous answer, we question whether the proposed changes to the PSI rules are an appropriate policy response. Therefore, we do not have a view on the substantial business assets test threshold.

Do you consider the net income threshold should be increased from $70,000 per year to $180,000?

While we do not agree with the proposed changes to the PSI rules, if progressed, an increase in the net income threshold will presumably carve out a large number of taxpayers from the regime. However, predicting annual net income for many businesses can be difficult, so it is likely that many businesses will still have to consider the PSI rules throughout the year due to such uncertainty.