Full corporate-personal tax integration

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1 A business can be run in a variety of different ways – as a sole trader, a partnership, a trust, or a company. Likewise, the tax treatment can vary in practice depending on the entity used to conduct the business. Having a variety of tax treatments can create economic distortions. This paper argues that improvements in efficiency and equity are possible by fully integrating the company and personal tax bases.

New Zealand's imputation regime results in distortions…

2 In substance, shareholders own the claims to a company's residual income after all other claimants have been satisfied. It follows that this residual income should, in principle, be taxed as if it were received directly by the shareholders. This is the perspective taken of company/shareholder taxation in this paper.

3 New Zealand is one of only a few countries with a dividend imputation regime. Imputation aims to ensure that, as much as possible, income earned by New Zealanders is taxed at their personal tax rates and that companies cannot be used to shelter income from higher rates of personal income tax.

4 Companies and unincorporated businesses are, to some extent, substitutable forms of business organisation and may be in direct competition with one another.[1] There is no perfect way of taxing companies and there are biases associated with any company tax system. The current company tax rules generally tax distributions from companies even where the distributions were not taxed at the company level. This means tax can influence decisions about legal form, and whether to retain rather than distribute earnings. Other disadvantages of imputation include:

- inducing pre-paying tax, transfer pricing to pay New Zealand tax and the use of alternative distribution tools such as special dividends and share buy-backs;[2]
- providing no direct benefit to foreign investors (except, in some cases, a reduction of withholding taxes);
- complicating the tax system as a result of the necessary integrity measures (such as anti-streaming and credit shopping rules); and
- burdening lower income earners where they end up with excess non-refundable imputation credits.

5 Many of the distortions noted in this paper could be removed by moving to a flat-rate tax system accompanied by cash transfers to individuals to achieve the desired degree of progressivity. Company income could be taxed at the single rate of tax and dividends made exempt. In New Zealand there has been little political appetite for such radical reform. If a

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[1] Businesses, in deciding on organisational form, must take into account non-tax as well as tax factors. As an example of these nontax factors, corporate but not unincorporated businesses automatically face limited liability and can list their shares on public exchanges, in principle making it must easier to raise funds from a large number of new investors.

[2] In the recent report *Imputation and the New Zealand Dividend Psyche* EY concluded that because corporates place such a high value on imputation, they apply a number of strategies to increase the available pool of credits.

personal tax base with progressive rates is to be continued, better integration of the personal tax base with the flat rate company tax base needs to be considered.

…that could be reduced through full integration…

6 A company in a tax system with full integration is essentially a look-through entity with income being attributed to the shareholders of the company. In effect, the integrated system removes company taxation. Full integration occurs where the total tax to the company and its shareholders equals what would have been paid if the shareholders had earned the income directly. The New Zealand Look-Through Company (LTC) regime is a type of full integration model as the company is essentially treated like a partnership and the income or loss of the look-through company is attributed to the shareholders.

7 This paper approaches full integration primarily as a means of reducing the distortions created by imputation and therefore improving economic efficiency. The main distortions being whether to invest in corporate rather than unincorporated form, and whether to retain rather than distribute earnings.[3] To the extent that the imputation regime distorts the choice of organisational form and dividend policy, economic resources can be misallocated.

8 Full integration would:

- improve vertical equity by removing the opportunity for high-rate taxpayers to use companies as a tax shield and the tax penalty faced by low-rate taxpayers;
- allow realised capital gains to be distributed without being subjected to the dividend rules; and
- mean returns from corporate share ownership would bear the same tax as the returns from investing in other ways and from personal effort, greater horizontal equity would be achieved.

…which is possible…

9 At the time imputation was implemented, a full integration company tax system was dismissed as being impractical.[4] Technology improvements mean a regime for companies that is similar to the Portfolio Invest Entity (PIE) regime could now be a feasible approximation for full integration. Under this approach a company would be liable to tax under current rules but the rate would be based on the marginal tax rates of shareholders: a hybrid allocation/flow-through basis similar to how multi-rate PIEs are taxed.

10 Companies would pay tax on behalf of the shareholders based on their marginal tax rates and any distributions to shareholders would be excluded income. Attributed income and tax could be prepopulated on shareholders tax returns and for many shareholders filing an annual return may not be required. If an investor advised a company incorrectly of their marginal tax rate they would be required to top up that tax by filing an annual return. A penal non-declaration rate could apply to shareholders that do not elect a rate.

11 A full integration regime would mean the imputation rules would be unnecessary, as would most, if not all, of the dividend and dividend withholding rules. Full integration would not, as explained below, alter the cost of capital for non-resident shareholders. However, it would increase the cost of capital for some domestic investors. For domestic investors

[3] The dividend and financing decisions of companies are not necessarily independent since the proportion of income distributed as dividends can affect the amount of capital required by companies.

[4] M Benge and T Robinson *How to integrate company and shareholder taxation* (Victoria University Press, Wellington, 1986).

offshore investment will become more attractive.[5] Many taxes increase the cost of capital. What is important is to minimise economic efficiency costs.

12 A full integration system is likely to collect more revenue than the existing imputation regime. Full integration would have no revenue impact for non-resident shareholders. However, for resident shareholders there would be an increase in the effective tax on retained earnings where shareholders are on the highest personal tax rate.

…but the detail is important

13 To implement the proposal it will be important to consider:

- *Different classes of shareholder* – Integration is relatively simple for companies with a single class of share (as required under the LTC regime). Different classes of share are not recorded with the Companies Office but must be kept on a company's own share register. The integration rules should maintain integrity across different classes of share to prevent abuse between high-rate and low-rate taxpayers.
- *Loss flow through* – Tax losses may arise because of real economic losses or because of tax preferences. In principle, there is no good rationale for denying shareholders the ability to offset company losses against their other income. However, allowing what amounts to a refund inherently involves an element of risk to the tax base. In addition, allowing flow through of losses may be detrimental to non-resident shareholders as they will be unable to use the losses.
- *Foreign direct investment* – About 33.8% of the New Zealand company tax base is owned by non-residents.[6] New Zealand not only has very mobile capital inflows, it also has an extremely mobile labour force. Arguably, keeping tax rates low across the board is a better approach than attempting to have low tax rates only on highly mobile workers.[7] This is facilitated by maintaining a robust company tax, which is a final tax on income from foreign direct investment. This means the company rate of 28% should continue to apply to foreign shareholders.
- *International tax issues* – Differences in how countries apply the fiscally transparent entity approach may create difficulties for non-resident shareholders and New Zealand's network of double tax agreements. The extent to which treaty partners, and New Zealand, adopt the Multilateral Instrument will address these issues.[8]
- *Interim tax payments* – Changes to the calculation methods for provisional tax would be needed to reflect that the tax rate will be an average across the shareholders' marginal rates and their respective shareholding interests.
- *Administrative issues* – Changes in tax liability resulting from amendments to assessments could be attributed to the shareholders at the time of amendment (rather than reopening the earlier period). This accords with the principle that shareholders

[5] If in an increasingly global market, foreigners are the "marginal investors" and investments need to generate a sufficient return to satisfy these non-resident foreign investors, there is a theoretical argument that imputation may not affect the cost of capital. Instead, it may be a subsidy to domestic investors.

[6] This only accounts for company tax collected from companies that are 50 percent or more owned by non-residents.

[7] Inland Revenue and the Treasury *New Zealand's taxation framework for inbound investment – a draft overview of current tax policy settings* (Inland Revenue, June 2016) at 13.

[8] Article 3 of *The Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit shifting* will ensure that income derived by or through a fiscally transparent entity will be considered to be income of a resident for treaty purposes but only to the extent that at least one of the jurisdictions treats the income as income of one of its residents under its domestic law.

own the claims to a company's residual income after all other claimants have been satisfied. Shareholding changes could be addressed by either an income spreading method or allowing the tax position of the company to be determined on the date of change.

- *Social policy integrity* – Similar to how income from unlocked PIEs is treated, the attributed income and tax should be included for Working for Families entitlement calculations and other social assistance purposes.
- *Transitional issues* – Companies with retained earnings (other than realised capital gains) will have an advantage if they are able to distribute these earnings tax free after the shift to full integration. Some form of grand-parenting could be used to limit or eliminate transitional gains.

A way forward

14 Given the downwards pressure on company tax rates globally, the integration of the corporate and personal tax bases is ripe for reform. While the detail of this proposal will be critical for success, the possibility of removing some of New Zealand's domestic distortions is attractive and deserves attention.