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WEEKLY COMMENT: FRIDAY 3 NOVEMBER 2017

1. The *Taxation (Annual Rates for 2016-17, Closely Held Companies, and Remedial Matters) Act 2017* (“the Closely Held Companies Act”) received the Royal assent on 30 March 2017. There are a number of changes affecting various parts of the Income Tax Act 2007 and the Goods and Services tax Act 1985.
2. This week I finish looking at the changes affecting closely held companies by looking at changes to the taxation of dividends under the resident withholding tax (“RWT”) rules and changes to the PAYE rules on shareholder employee salaries.

RWT impact on backdating a dividend

3. Under the fringe benefit tax (“FBT”) rules, when an employee has an employment-related loan that is subject to FBT, s. RD 36(1) allows any income applied in an income year towards repayment of the loan to be treated as applied towards repayment on the first day of the income year, or if the loan was advanced during the year, the date of the advance.
4. Similarly, under the dividend rules, when a shareholder has an interest-free or concessional interest overdrawn current accounts at year end that would result in a deemed dividend, s. CD 39 allows any salary, wages, extra pay, dividends, or interest payable by the company to the borrower, that is income of the borrower in the tax year or an earlier tax year. To be treated as as applied towards repayment on the first day of the income year, or if the loan was advanced during the year, the date of the advance.
5. However, s. RD 36(2)(b) (in the case of an employment loan subject to FBT) and s. CD 39(9)(c) (in the case of a deemed dividend), required that no resident withholding tax (“RWT”) must be deducted from a dividend that is applied towards repayment in order for the back dating to be allowed.
6. Due to the difference between the company tax rate of 28% and the top marginal tax rate of 33%, the back dating ceased to work, as even fully imputed dividends had RWT deducted of at least 5%.
7. Amendments to ss. RD 36(2)(b) and CD 39(9)(c) will allow the backdating to apply as intended. Specific provision has been made, by introducing a new s. RD 36(2)(b)(ii) and a new s. CD 39(9)(c)(ii) to allow a fully imputed dividend to be used for back dating repayment of loans.
8. The new rule applies from 1 April 2008 for the 2008-09 and subsequent income years. However, taxpayers cannot amend returns filed between the 2008-09 income year and 3

May 2016, the date of introduction of the Bill corresponding to the Closely Held Companies Tax Act.

RWT optional on dividends between companies

9. Effective from the date of enactment of the Closely Held Companies Act, 30 March 2017, a new s. RE 2(5)(fb) has been inserted with the effect that a dividend paid by a company and derived by another company is excluded from being a “dividend for the purposes of the RWT rules if:
 - (a) The dividend is fully imputed; and
 - (b) The paying company chooses to exclude the dividend from being resident passive income.
10. Officials have recognised that the requirement for corporates to deduct RWT from intercorporate dividends gave rise to unnecessary compliance costs in circumstances where the paying company had to deduct an additional 5% RWT and the recipient company could not use the credit and had to seek a refund.
11. The amendment allows a company to opt out of withholding RWT on a fully imputed dividend paid to another company.
12. It is stated on page 50 of *Tax Information Bulletin*, Vol. 29, No. 5, June 2017 (“the TIB Item”) that:

“The ability not to withhold has been made optional because for some paying companies (particularly those that are widely held) an outright requirement not to withhold RWT on fully imputed dividends may raise compliance costs. This is because they will need first to establish which shareholders are corporates and those that are not, and differentiate between these two groups within their systems.”

RWT when cash and non-cash dividends are paid contemporaneously

13. Section RE 13 sets out the calculation of RWT when a person pays a dividend other than a non-cash dividend. The formula applies only to the cash dividend. Any non-cash dividend paid is treated separately and the RWT relating to the non-cash dividend is separately calculated under s. RE 14.
14. The formula in s. RE 14 is a “gross up” whereby the RWT is calculated as if the non-cash dividend was the net amount received after the deduction of RWT from a notional grossed up amount.
15. Officials have recognised that when a cash and a non-cash dividend are paid together, the combined RWT calculated under ss. RE 13 and RE 14 is higher than it would be if the dividends were taken together as a single dividend and the cash portion was sufficient to finance the RWT deduction.
16. New s. RE 14B has been inserted, effective from the date of enactment of the Closely Held Companies Act, 30 March 2017, to allow a cash and a non-cash dividend to be treated as a single dividend for RWT purposes.
17. Section RE 14B applies when a person has made an election under ss. RE 13(1B) and RE 14(1B) and the amount of the cash dividend paid at the same time as the non-cash

dividend is equal to or greater than the RWT on the combined dividend calculated under s. RE 14B(2) as follows:

tax rate × (dividends + tax paid or credit attached) – tax paid or credit attached.

18. In the above formula:

(a) "Tax rate" is currently 33%;

(b) "Dividends" is the total of the cash and non-cash dividends pre-tax;

(c) "Tax paid or credit attached" is the total of the imputation credits attached and any foreign withholding tax if the dividend is a foreign dividend.

19. The elections required in ss. RE 13(1B) and RE 14(1B) essentially provide that those sections do not apply to a combined cash and non-cash dividend if the person chooses to apply s. RE 14B and the requirements of s. RE 14B are met.

20. It is noted on page 51 of the TIB Item that if a taxpayer provides a non-cash dividend and wishes to provide a cash dividend simply to satisfy the RWT liability on the non-cash dividend then the following formula provides how much cash dividend is required:

cash dividend = 0.4925 x non-cash dividend – tax paid or credit attached

21. The following example is provided:

Co. X wishes to provide a non-cash dividend of \$360. The non-cash dividend has imputation credits of \$140 attached. Co. X wishes to provide a cash dividend solely to satisfy the RWT liability.

cash dividend = 0.4925 x 360 – 140 = \$37.30

If Co. X provides a cash dividend of \$37.30, the RWT payable is also \$37.30.

PAYE on shareholder employee salaries

22. The previous rules allowed shareholder-employees to treat their income as subject to provisional tax and not subject to PAYE tax deductions if the requirements of s. RD 3(2) to RD 3(4) were met. However, there was no ability to combine PAYE tax deductions (for regularly paid portions) with provisional tax (for irregular payments).

23. Effective from the date of enactment of the Closely Held Companies Act, 30 March 2017, an amendment has been made so that shareholder-employees of close companies who receive both regular salary or wages throughout the year and variable amounts of other employment income are able to elect to split their income so that the base salary is subject to PAYE and the variable amount is paid out before tax.

24. The amendment is potentially more restrictive, however, in that, once an election has been made to treat income entirely as non-PAYE or as subject to PAYE for regular amounts, there is no ability to switch from PAYE to non-PAYE.

25. The pre-existing provisions in ss. RD 3(2) to RD 3(4) have been repealed.

26. New s. RD 3B allows all amounts paid to a shareholder-employee, of a company that is not a look-through company and is a close company or has 25 or fewer shareholders, to be not subject to PAYE tax deductions if:

(a) The shareholder-employee does not derive salary or wages:

(i) Of a regular amount for regular pay periods of 1 month or less throughout the year; or

(ii) That total 66% or more of the shareholder-employee's gross income for the year as an employee; or

(b) An amount is paid to the shareholder-employee as income that may later be allocated to the as an employee for the income year.

27. However, s. RD 3B(2) states that this rule does not apply if either this section or s. RD 3C (the section allowing a combinations of PAYE tax and provisional tax – see below) has applied previously for I of the last 3 years and then ceased to apply.

28. New s. RD 3C provides for a combination of PAYE tax deductions and provisional tax in relation to amounts paid to a shareholder-employee, of a company that is not a look-through company and is a close company or has 25 or fewer shareholders, as follows:

(a) Payments of salary or wages of a regular amount for regular pay periods derived as an employee are treated as PAYE income payments; but

(b) All amounts paid as income that may later be allocated to the shareholder-employee as an employee for the income year are treated as income other than from a PAYE income payment.

29. Again, s. RD 3C(2) states that this rule does not apply if either this section or s. RD 3B (the section allowing all income to be subject to provisional tax – see above) has applied previously for I of the last 3 years and then ceased to apply.

30. The restriction on switching between methods is explained on pages 51 – 52 of the TIB Item as follows:

To ensure that the ability to switch between provisional tax and the PAYE system is not used inappropriately, there are rules to prevent taxpayers “flip flopping” between the options. These rules provide that:

(a) If a taxpayer has previously elected to use either the provisional tax method (in s. RD 3B) or the split provisional tax and PAYE method (in s. RD 3C) for their shareholder salary payments; and

(b) The taxpayer then elected a different treatment for their shareholder salary payments; then

(c) The taxpayer cannot elect to use either of the provisional tax methods for three income years.

31. The following example is provided:

Steve is a shareholder employee of Steve Co. In the 2018–19 income year, Steve receives a shareholder salary of \$50,000 which he elects to have treated under the provisional tax rules.

In the 2019–20 income year, Steve receives shareholder salary of \$50,000 which he elects to have treated under the PAYE rules.

As Steve has elected out of the s. RD 3B provisional tax option, Steve cannot elect to use the s. RD 3B and RD 3C provisional tax options until the 2023–24 income year.



Arun David, Director,
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