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WEEKLY COMMENT: FRIDAY 31 MAY 2024

1. The *Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Act 2024* (the "Multinational Tax Amendment Act 2024"), with a date of assent of 28 March 2024, contains a number of major amendments. In the past two weeks, I have looked at the changes to the trust tax rules. This week, I complete that review by looking at the earlier information issued by Inland Revenue on the increase in the trust tax rate and Inland Revenue's consequent perception of certain transactions that affect the taxable income of trusts.

General Article on the increase in the trustee tax rate to 39%

2. Inland Revenue issued a General Article GA 24/01 Proposed increase in the trustee tax rate to 39% *Tax Information Bulletin*, Vol. 36, No. 2, March 2024. Inland Revenue noted that "Inland Revenue has been asked to provide guidance around how it may perceive some taxpayer transactions and structural changes." In GA 24/01, Inland Revenue:

   (a) Comments on specific transactions and structural changes that have been raised in questions directed at Inland Revenue; and

   (b) Provides some examples of behaviours that might cause Inland Revenue to have concerns or ask further questions.

Specific transaction 1: Change in dividend-paying policy

3. In this example transaction, a company owned by a trust changes its dividend paying policy either:

   (a) To pay out retained earnings before the increase in the trust tax rate to 39% on 1 April 2024; or

   (b) To reduce dividends following the increase in the trust tax rate to 39% from 1 April 2024 onwards.

4. Inland Revenue states that:

   (a) Inland Revenue considers that where a company changes its dividend paying policy while taking into account the funding needs of shareholders and applicable tax rates, this is unlikely, without more (such as artificial or contrived features), to be tax avoidance;

   (b) An example of where Inland Revenue might have concerns is where, despite it being possible for a company to "pay" a dividend by crediting shareholder current accounts, the company objectively has no real ability to pay those credit balances if it was to be liquidated.

5. The latter comment is interesting because in the context of the imputation credit shareholding continuity rules, Inland Revenue stated, in "Streaming and refundability of imputation credits" Government tax policy discussion document, August 2008, in paragraph 3.29 that:

   "Generally, when a continuity breach is imminent, a company may take action to prevent the loss of the imputation credits to shareholders by paying a dividend (often by way of a bonus issue) to reduce the imputation credit account to zero. Therefore the continuity rule can fill a useful function in that it can prevent the build-up of unusable credit balances."

6. A taxable bonus issue is often used in such situations because the company does not have the cash to pay a dividend. The capitalised retained earnings are also unlikely to be paid out, in the form of a share repurchase, because the company has no cash.

7. Inland Revenue does not appear to have concerns about capitalisation of retained earnings before a shareholding continuity breach in order to use available imputation credits. Therefore, it is difficult to see why a capitalisation of retained earnings prior to the 39% tax rate change would be of any concern, even if the company had no cash to repurchase the taxable bonus issue. Equally, it is difficult to see why a crediting of a shareholder current account prior to the 39% tax rate change would be of any concern, even if the company was not in a position to pay the resulting shareholder credit balances.

8. In *Commissioner of Inland Revenue v Albany Food Warehouse Limited* [2009] NZHC 617, the High Court held that a dividend had been paid in circumstances where the shareholders had resolved that "receipt by shareholders of the dividend approved by directors on 6 June 2001 will be subordinated to the payment of all liabilities incurred by the company in the normal course of business and will only be paid as and when finance permits".

Specific transaction 2: Distribution to a beneficiary

9. Inland Revenue notes in GA 24/01 that the use of a discretionary trust was considered in Questions We've Been Asked QB 23/02 Income tax: scenarios on tax avoidance – 2023 No 2 *Tax Information Bulletin* Vol. 35, Mo. 2, March 2023.

10. Scenario 2 in GA 24/01 considered the example of the trustees of a trust paying or vesting income in an income year to beneficiaries that are either:

    (a) An individual adult beneficiary who is taxed on the beneficiary income at the lowest marginal tax rate; or

    (b) A corporate beneficiary (that may or may not be solvent) with total tax losses available in that year equal to, or greater than, the beneficiary income (if the corporate beneficiary is a close company, current law requires the beneficiary income to be taxed at 39% as trustee income, as discussed in last week's *Weekly Comment*); or

    (c) A corporate beneficiary, where the beneficiary income is a dividend from a foreign company and exempt income of the beneficiary under s CW 9 (the implications of this under current law were also discussed in last week's *Weekly Comment*).

11. The distributions are valid under trust law and under the trust deed, all beneficiaries are NZ tax residents, and the trust is a complying trust.

12. Inland Revenue stated that the Commissioner's view is that, without more, s BG 1 would not apply to the arrangement. Variations to the facts that may lead the Commissioner to reach a different view are discussed as follows.

13. On some facts, it will be arguable that no distribution of income to a beneficiary of the trust was made from a commercial or economic perspective and this may be because of artificial or contrived elements or steps in the arrangement or the use of pretence, for example:

    (a) Where it is arguable whether, in commercial or economic reality:

        (i) The beneficiary is a beneficiary of the trust, or

        (ii) A distribution of income was made to the beneficiary;

    (b) Consideration would need to be given to various facts, including (but not limited to):

        (i) The timing and pattern of the addition or removal of beneficiaries;

        (ii) How and when the income was distributed (e.g., whether authorised distributions are paid in cash or credited to beneficiaries' current accounts);

        (iii) Any facts indicating that, in commercial and economic reality, parties other than the trustees or the beneficiaries nominated to receive distributions obtain the use and benefit of the income; and

        (iv) Any facts indicating that, in commercial and economic reality, there is no realistic prospect of the beneficiaries ever benefiting from the income allocated to them;

    (c) Although argued under provisions other than the trust rules, *Krukziener v Commissioner of Inland Revenue* HC [2010] HZHC 1714; (2010) 24 NZTC 24,563 is an example of where, in the context of s BG 1, a court clearly considered that the use and benefit of income distributed by trustees was enjoyed by a person other than the beneficiaries nominated to receive the distributions;

    (d) Another situation where the Commissioner may reach a different conclusion is where an arrangement is contrary to Parliament's purposes for provisions of the Act, other than the trust rules, while it is not possible to be specific about such arrangements due to the range of arrangements and other provisions of the Act that could arise, it is likely that, unlike the current scenario, such arrangements would involve additional entities and steps that contribute to the potential for these arrangements to be regarded as tax avoidance arrangements.

14. However, the fact that in any income year the trustees have resolved to pay beneficiary distributions by credit to account and retain the funds for use within the trust would not, on its own, indicate Parliament's purposes for the distribution of beneficiary income were not being given effect to (note that there is potential for a beneficiary to be treated as a settlor of the trust under s HC 27, however, from 1 April 2020, s HC 27(6) provides that a beneficiary is not a settlor of the trust solely as a result of being owed money by a trustee if the amount owing is not more than $25,000 or the trustee pays market rate interest on the amount).

Specific transaction 3: Transfer of income-earning assets to a company

15. Inland Revenue considers that incorporating a company to hold income-earning assets while taking into account applicable tax rates is unlikely, without more (such as artificial or contrived features), to be tax avoidance.

16. Examples of some circumstances where Inland Revenue might have avoidance concerns around the use of a holding company are set out in Revenue Alert RA 18/01 *Tax Information Bulletin* Vol. 30, No. 4, May 2018 (in the context of where a holding company is interposed between an existing operating company and a trust) and Revenue Alert RA 21/01 *Tax Information Bulletin* Vol. 33, No. 4, May 2021 (in the context of where personal services income is diverted by structuring revenue-earning activities through a company).

17. RA 18/01 "Dividend stripping – some share sales where proceeds are at a high risk of being treated as a dividend for income tax purposes" concerns related party scenarios where some or all of the amount received by the seller is in substitution for a dividend likely to have been derived by the seller but for the sale of the shares.

18. Inland Revenue maintains that the greater the similarity between the seller's pre and post-sale ownership of the target company, the greater the risk that the transaction should be treated as a tax avoidance transaction. The risk exists regardless of whether or not the target company has liquid assets or retained earnings at the time of sale. For example, the target company may have appreciated assets, or goodwill that has emerged over time.

19. An example of this kind of dividend stripping transaction is *Beacham v CIR* [2014] NZHC 2839; (2014) 26 NZTC 21-111. In this case, the shareholders sold Beacham Holdings Limited, which had $1.8m of retained earnings, to another wholly-owned company, Beacham Group Limited in exchange for a debt obligation of $1.84m. The sale journal entries included elimination of amounts owed by the shareholders to Beacham Holdings Limited, with the remainder left owing as a debt. The court held it was a dividend stripping transaction and the shareholders were taxable on the sale proceeds as if they were a dividend.

20. The Commissioner's view is that where shares in a company are sold to another company in which the same shareholders have a significant ownership interest, the anti-avoidance riles can apply in a wider range of circumstances than those in the *Beacham* case, such as where:

    (a) The company being sold has no retained earnings and the purchase price is left owing to the vendors;

    (b) A holding company structure is used to facilitate the exit of a shareholder, or the merger of two companies;

    (c) An arrangement inappropriately creates available subscribed capital ("ASC") for a company when a shareholder has not provided anything for the issue of the shares.

21. Three examples were provided in RA 18/01 highlighting the Commissioner's concerns:

    (a) Example 1 concerned the sale by a family trust, of a company with no retained earnings, for a price equal to an independent valuation of $3.5m, to a wholly-owned holding company, with the price remaining outstanding as a debt owed to the trustees, with tax-free debt repayments to the trustees being substituted for taxable dividends (as had been paid in earlier years);

(b) Example 2 concerned a purchase by a trust of a half-share in a company of which it owned the other half-share, through a series of transactions which included the sale of the trust's half-share in the company to a holding company, and the purchase of the other half-share by way of a bank loan taken out by the company, with the end result that the trust had acquired a half-share funded by the company (via the bank loan) and had sold its own half-share to the holding company for a debt back, which the Commissioner considered was a transfer of value from the company to the trust equal to the purchase price of the company;

(c) Example 3 concerned a merger of 2 companies through the creation of a holding company, sale of the 2 companies to the holding company with a debt due to the shareholders, and capitalisation of the debt, which the Commissioner considered could be tax avoidance due to the transfer of value to the shareholders of the purchase price, leaving aside the fact that any ASC created would be ineffectual due to the operation of s CD 43(9) and s CD 43(10) which limit ASC when there is a share-for-share exchange.

22. RA 21/01 "Diverting personal services income by structuring revenue earning activities through a related entity such as a trading trust or a company: the circumstances when Inland Revenue will consider this arrangement is tax avoidance" concerned avoiding the top marginal rate of 39% introduced on 1 April 2021 through using a lower tax rate entity (at the time) such as a trust, or a company.

23. RA 21/01 states that it reiterates the Commissioner's view on this matter which follows the Supreme Court's decision in *Penny and Hooper v CIR* [2011] NZSC 95*.*

24. Where the business involves the provision of personal services, Inland Revenue is likely to examine closely any arrangement where the individual service provider (usually the real owner or controller of the business) is not receiving a significant portion of the profits derived from the business. This is particularly so where there is an absence of other business profit drivers and other non-tax reasons do not justify the level of remuneration received by the individual.

25. Inland Revenue considers that a combination of some or all of the following factors may result in a close look at the business structure:

(a) The controller of the business arranges for an entity, such as a trading trust or company, to operate and own the business, and the operating entity engages or employs the individual (or contracts for their services);

(b) The business may not in substance be operated according to the terms of the arrangements entered into: this will involve examining the agreements themselves, the manner in which they are actually implemented and also whether the overall arrangement is commercial having regard to a comparison with relevant standard business practices;

(c) The degree to which the individual or their family ultimately controls the entity, its economic product and cash flows from the business;

(d) Whether there is a redistribution of the underlying income from the entity to the individual or to family members, which is usually via a trust but there are other mechanisms, for example, by way of employment of the family members perhaps at inflated salaries, or related party loans, or the payment of management and other service fees to associates; and

(e) The extent to which, as a consequence of the arrangement, significant tax benefits are obtained e.g. where the entity and/or any beneficiaries or shareholders pay lower marginal tax rates than would have been payable by the individual, but for the arrangement.

26. Where an arrangement involves a restructure of an existing business, a further factor will be whether the business operates substantially as it did before its transfer to the related entity.

27. Inland Revenue accepts that even if all or most of the above factors may be present, the arrangement may not constitute tax avoidance because there are legitimate reasons for adopting a particular business structure. Businesses can also legitimately make decisions about whether or not, or the extent to which, profits are to be retained or distributed.

28. It is stated in RA 21/01 that the Commissioner will be more concerned with arrangements that have non arms-length factors present, especially where the individual service provider is not adequately remunerated for their contribution to the business. The focus will be to look at the totality of the arrangements.

29. Inland Revenue stated they are more more likely to examine arrangements where the total remuneration and profit distributions received by the individual service provider (and controller of the business) is less than 80% of the total distributions received by that individual, their family and related entities. However, this should not be relied on as a safe harbour as neither the legislation nor the Supreme Court prescribed a minimum percentage to distribute, and Inland Revenue will apply the matters discussed in the *Penny and Hooper* judgment when reviewing taxpayer arrangements.

30. Inland Revenue notes that whether or not the arrangement under consideration is a tax avoidance arrangement in relation to the tax payable on the entity's distributed profits in any given income year will depend on an examination of:

(a) The reality of the business' structure and how it operates commercially;

(b) Whether and how the profits of the business have been distributed in substance - including whether the individual and their family continue to receive the benefit of all profit distributions from the business;

(c) Whether the remuneration received by the individual service provider appropriately reflects the individual's contribution to the business' profit; and

(d) Whether there are particular non-tax reasons justifying a departure from that standard.

31. Arrangements could be reconstructed where it is determined that there has been tax avoidance, and late payment penalties, use-of-money interest and shortfall penalties may be applied.

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