

# The taxation of distributions from profit distribution plans

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*An officials' issues paper*

June 2009

*Prepared by the Policy Advice Division of Inland Revenue and by The Treasury*

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# 1. Introduction

- 1.1 The Government announced in April that it intends to clarify the law to ensure that bonus issues of shares distributed under profit distribution plans (PDPs) are taxed in the same way as shares issued under other dividend reinvestment plans (DRPs). Because PDPs make use of a different form of transaction that is not explicitly covered by the tax rules, shareholders investing under PDPs may, in certain cases, have a tax advantage over those investing under DRPs.
- 1.2 As pointed out in the Government's announcement, there is no clear reason why one form of dividend reinvestment plan should be tax-advantaged over the other.
- 1.3 The intention is to confirm that distributions of bonus shares to shareholders under both plans would be taxable as dividends.
- 1.4 This issues paper has been prepared by officials from the Policy Advice Division of Inland Revenue and from the Treasury, as part of the consultation process. We want to ensure that the proposed law changes work effectively and fairly from a compliance and company law perspective and that the principles of the imputation system are adhered to. We are particularly interested in hearing of any practical difficulties that the proposed change might create for affected companies or their shareholders. Submissions will be taken into account when we make formal recommendations to the Government on the final form of the change.

## How to make a submission

- 1.5 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for officials from Inland Revenue and the Treasury to contact you about your submission to discuss the points it raises. Submissions should be made by 7 August 2009 and be addressed to:

The Taxation of Profit Distribution Plans  
C/- Deputy Commissioner, Policy  
Policy Advice Division  
Inland Revenue Department  
PO Box 2198  
Wellington 6140

Or e-mail [policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz) with "PDPs" in the subject line.

- 1.6 Submissions may be the source of a request under the Official Information Act 1982, which may result in their publication. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If you think any part of your submission should properly be withheld under the Act, you should indicate this clearly.

## **2. The different tax treatments under DRPs and PDPs**

### **How dividend reinvestment plans work**

- 2.1 Under a dividend reinvestment plan (DRP), the company provides shareholders with the option of reinvesting their cash dividends in shares of the company. This can be advantageous for the company, allowing it to maintain a dividend payment policy, while providing an opportunity to increase cash retentions. DRPs are also convenient for shareholders, offering a convenient method for them to reinvest their cash dividends in a company, at a lower cost and effort than purchasing shares on the market. There appear to be two types of DRPs.

### **Standard DRPs**

- 2.2 Under a standard DRP, when a dividend is declared, shareholders are offered the option of receiving a cash dividend or receiving a bonus issue of shares. The option is generally exercisable before the dividend is paid. In the standard case, a cash dividend is paid unless the shareholder opts otherwise. Receipt of cash is the default option.
- 2.3 Distributions of cash or shares under a DRP are treated as a taxable dividend in the hands of the shareholder. If a shareholder chooses to receive a bonus issue of shares instead of a cash dividend the issue is treated as a “bonus issue in lieu”, which is a dividend for tax purposes. Imputation credits may be attached to distributions under a DRP.

### **PDPs**

- 2.4 A PDP reverses the priority of these options. Under a PDP, the company formally issues shares to all dividend recipients. However, shareholders are able to elect, before the dividend is paid, to have their shares immediately repurchased by the company, for an amount equal to the cash value of the dividend. If the shareholder does not make an election, the default option is to receive shares.
- 2.5 PDPs have proven successful in New Zealand for obtaining reinvestment rates between 60 to 90 percent of dividends declared. This rate is very high compared to that achieved under DRPs. This result is particularly attractive to companies in the current economic and financial environment as it increases cash retention and reduces the need for companies to raise external financing to fund operations and investment programmes.

- 2.6 The tax treatment of distributions under a PDP was the subject of a specific Inland Revenue product ruling in 2005.<sup>1</sup> The ruling held that a distribution of shares under a PDP is treated as a non-taxable bonus issue and consequently does not constitute a dividend in the hands of the shareholder. This ruling was made subject to certain conditions – in particular, that the company making the bonus issue has sufficient credits in its imputation credit account to have fully imputed a cash dividend equal to the bonus issue not redeemed.

### **Lack of certainty and consistency**

- 2.7 Taxpayers have expressed concern about the uncertainty in relation to the tax treatment of PDPs under current tax law. The uncertainty arises because PDPs do not appear to be explicitly covered by the legislation.
- 2.8 There appears to be a lack of consistency between the two types of share issues. Under standard DRPs, shareholders choose between receiving cash dividends or shares. Both are taxed as dividends in the shareholders' hands, and imputation credits can be attached.
- 2.9 PDPs, on the other hand, make use of a different form of transaction, to provide shareholders with the option of receiving shares or cash. In this case, when the shareholder chooses to retain shares the retention of the shares may not be taxable as a dividend. For certain taxpayers, this may provide a tax advantage relative to those investing under standard DRPs. Shareholders on higher tax rates would face a lower tax impost than that applied to other dividend reinvestment plans.

### **Adherence to the rules underpinning the imputation system**

- 2.10 The imputation system is based upon a number of rules applying to the taxation of income that is earned by a company and then distributed to shareholders. The rules are:
- As far as possible, taxing income derived through companies at the tax rates of the shareholders who own the company at the time the income is derived.
  - Ensuring that New Zealand source-basis taxation is retained – that is, taxing non-residents on the income that is derived through their investments in New Zealand.
  - Providing no credit for income that has not been subject to company tax (unimputed income), so that the full amount of the underlying income is subject to shareholder level tax.

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<sup>1</sup> A Product Ruling was issued to SkyCity Consolidated Group in December 2005. See *Tax Information Bulletin* (Volume 18, Number 2).



- Ensuring imputation credits attached to dividends reflect the proportionate share of income earned by the company on behalf of the shareholder. A series of rules are provided to ensure that imputation credits cannot be “streamed” to taxpayers who can make the greatest use of them.

2.11 The appropriate taxation of DRPs, **including PDPs**, should reflect these principles.

### **3. The proposed solution**

- 3.1 Concerns about uncertainty and inconsistency in the taxation of PDPs should be resolved by ensuring that the legislation clearly treats distributions to shareholders under PDPs in the same way as distributions to shareholders under a standard DRP. It should also ensure that the tax treatment of PDP distributions is consistent with imputation principles. Consequently, the proposed solution would treat a distribution of shares under a PDP as a taxable dividend.

#### **How the law could be amended**

- 3.2 Current law includes the concept of a “bonus issue in lieu”, a taxable dividend. In essence, a bonus issue in lieu arises when a shareholder is explicitly given a choice between receiving a “bonus issue” or a cash dividend.
- 3.3 The reason for deeming a bonus issue in lieu to be a taxable dividend is because of concerns about potential opportunities for imputation credit streaming. Specifically, if a bonus issue in lieu was not taxable there is concern that shareholders who are able to use imputation credits would choose to receive a cash dividend, with imputation credits attached, while those shareholders who cannot use the imputation credits would choose a non-taxable bonus issue.
- 3.4 The proposed legislative amendment would include the issue of bonus shares within the definition of “bonus issue in lieu” when shareholders can opt for the company to repurchase those shares.
- 3.5 One concern about this amendment is that treating the issue of shares under a PDP as a bonus issue in lieu and, consequently, as a taxable dividend could lead to double taxation for a shareholder who chooses to have those shares repurchased immediately by the company. That could happen if the repurchase of the shares by the company did not satisfy the “bright-line tests” set out in income tax law.<sup>2</sup> If that happened, the repurchase proceeds would also be treated as a taxable dividend.
- 3.6 In such cases double taxation could be eliminated by excluding the repurchase from the dividend definition. We are also considering how the rules would work when a company held the bonus shares as treasury stock.<sup>3</sup>

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<sup>2</sup> If a distribution on the repurchase of a share is to be sourced from subscribed capital and not be deemed a dividend, the distribution must exceed certain thresholds or “brightlines” contained in section CD 22 of the Income Tax Act 2007. Different thresholds apply depending on whether the distribution occurs in a pro rata cancellation or as a result of a repurchase from selected shareholders.

<sup>3</sup> Treasury stock is a purchase by a company of its own shares where the company determines not to cancel the shares. A company may not apply this treatment to more than 5% of its shares.

- 3.7 We are particularly interested in hearing about any difficulties the proposed solution might give rise to – whether in relation to company law, administration or compliance.

### **Legislative detail**

- 3.8 The current definition of “bonus issue in lieu” in section YA 1 is as follows:

“Bonus issue in lieu” means a bonus issue made, on or after 1 October 1988, under an arrangement conferring on shareholders of a company an election whether to receive –

- (a) a bonus issue; or
- (b) money; or
- (c) money’s worth, other than money’s worth that is a bonus issue.

- 3.9 The definition of “bonus issue in lieu” in section YA 1 could be amended along the following lines:

“Bonus issue in lieu” means a bonus issue made, on or after EFFECTIVE DATE, under an arrangement conferring on shareholders of a company an election whether to receive –

- (a) money; or
- (b) money’s worth, other than money’s worth that is a bonus issue; in lieu of or in exchange for –
- (c) the subsequent repurchase of the bonus issue; or
- (d) the right to receive the bonus issue.

### **Date of application**

- 3.10 The proposed legislative amendment would have prospective application. Given there is no necessity for this amendment to operate from the beginning of an income year, officials suggest that the amendment apply to distributions from a fixed date on or after the date of enactment.

### **Questions for submissions**

- 3.11 Does the proposed legislative solution ensure consistency with the rules that underpin New Zealand’s imputation system?
- 3.12 Would it create any difficulties in relation to company law or compliance? If so, please specify what they are and how they could be dealt with, in your view.

3.13 In practice, is double taxation likely to occur as a result of the proposed amendment? If so, please specify how this concern could be dealt with, in your view.